From Subprime Mortgages to Subprime Credit Cards

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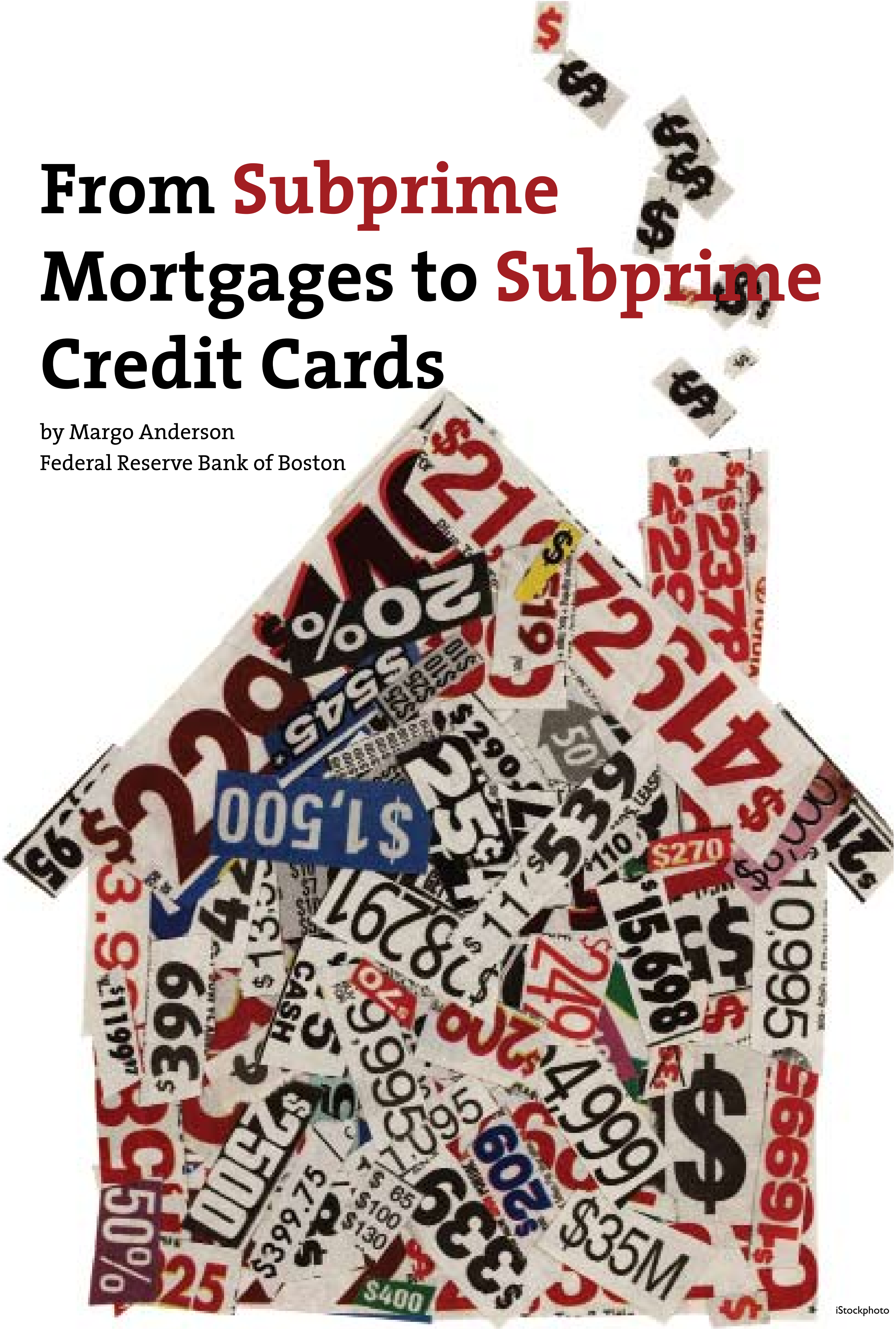

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In the wake of the subprime housing crisis, there are indications that subprime credit cards may be the next turbulent sector. According to Federal Reserve statistics, credit card charge-offs (loans removed from the books and declared a loss) rose almost three-quarters of a percent during the first quarter of 2008 up to a level of 3.94.[1] At the 100 largest banks, delinquencies increased from 4.24 percent to 4.47 percent (the ratio of loans 30 days or more overdue to total loans). At the same time, credit card giant Capital One Financial Corp. cut its fourth quarter earnings estimate and reported a $1.9 billion provision for losses from loans. HSBC Holdings plc. took a $1.4 billion charge on its American consumer-finance business, which was partly attributable to weakness in the credit card sector.[2] Even American Express, which boasts the most affluent customer base, took a fourth quarter charge for rising delinquencies and charge-offs.[3]

Subprime Borrowers

Despite these potentially threatening signs, the market research groups Synovate and Mintel note that card companies are actively courting subprime customers. (See "Who Is a Subprime Borrower?") During the latter half of 2007 credit card companies increased solicitations to subprime borrowers by 41 percent.[4]

Industry observers worry that these people will accept the credit card offers because they can no longer use the equity in their homes for cash, given declining housing values. That could spell trouble for credit card issuers and the markets as a whole. Similar to mortgages, credit card loans are organized into categories by risk level, packaged, sold and resold as collateralized debt obligations (CDOs). If consumers were to become delinquent in large numbers, the value of these obligations would decrease, potentially leading to investment losses similar to those experienced within the mortgage industry. In fact, in the case of mortgage CDOs, even the perception that mortgages might be delinquent has reduced the value.

Subprime Credit Card Business Model

After the recent subprime mortgage debacle, it may seem surprising that credit card companies heavily solicit subprime consumers. Industry insiders argue, however, that the subprime credit card business differs from the subprime mortgage business in the way it is structured, and a confluence of events could make subprime consumers an attractive and profitable customer base.

Initially, credit cards had fixed rates of around 20 percent and few fees.[5] But today many card issuers embrace a practice called risk-based pricing. Cards have more diverse interest rates and higher fees depending on cardholder creditworthiness. According to data reported to the U.S. Government Accounting Office in 2005, about 80 percent of credit card accounts have interest rates of less than 20 percent; 40 percent have rates below 15 percent. However, card companies assessed late fees on 35 percent of accounts and over-limit fees on 13 percent of accounts.

All cardholders are affected to some degree by risk-based pricing, but subprime consumers are most adversely affected. Companies charge them high up-front fees and provide small credit limits. Some of the cards in the subprime category allow credit of only $250.[6] Card issuers immediately deplete cardholder credit availability by charging a number of fees. On a credit limit of $250, a cardholder may be left with only $71 in available credit. (See "Fees for Issuance or Availability of Credit.")

These types of cards are profitable for several reasons. Low credit limits ensure that card companies don't incur great risk on customers with poor credit histories. High up-front fees mean that even if customers default on some of the debt, the card company will still have taken in money. And they may earn extra money from credit insurance. In that line of business, borrowers pay a percentage of their balance to the card company on a monthly basis in exchange for the right to freeze or suspend the obligation to pay the card balance in prescribed circumstances.

To address complaints from consumers, the Federal Reserve Board of Governors made several proposed rule changes in both 2007 and May 2008. The proposed rules include changes to Regulation Z, which enforces the Truth in Lending Act, and complementary revisions to Regulation AA, which prohibits unfair and deceptive practices.[7] For instance, if a card issuer imposes required fees in exchange for a credit card, and if the total of those fees equals 25 percent or more of the minimum credit limit offered on the card, then the card company would have to include a table outlining the remaining available credit. That and other changes to the regulation of open-end credit are pending, but in general they aim to ensure that the terms of the credit offer are "clear and conspicuous."[8]

The 2005 Bankruptcy Law

Another reason that credit card companies are willing to lend to subprime borrowers relates to recent changes to federal bankruptcy laws. In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act. Debtors who make above their state's median income and have extra money after allowable expenses must repay some of their debt even if they enter bankruptcy. The law is more stringent than the older law, which allowed a bankruptcy judge to decide who could walk away from their debt.

That change opened a new marketing opportunity for credit card companies because the law makes it more likely that

Fees for Issuance or Availability of Credit: An Example

Available Credit on Card	$250
Account Set-up Fee	$29 (one-time fee)
Program Fee	$95 (one-time fee)
Annual Fee	$48
Monthly Servicing Fee	$ 7 (x 12 months is $84 in a year)
Total Fees	$179
Credit Left After Fees	$71

Who Is a Subprime Borrower?

A determination about whether a borrower is prime or subprime is based largely on the borrower's credit score.

The credit score is derived from the consumer's credit history, which is collected by credit reporting agencies like Experian, Equifax, and Transunion. These companies compile information about the borrower's timeliness in paying bills, debts sent to debt collection agencies, amounts of outstanding debt, and the number, type, and age of credit accounts. Whereas credit reporting agencies compile credit information, a company called Fair Isaac & Co. transforms credit histories into credit scores using a proprietary formula. The scores range from 300-850. A score of less than 660 is considered subprime.[a] Lenders use credit scores to make lending decisions because they believe that the historical data represented in the credit score can predict a borrower's likelihood to repay a loan. About 27 percent of the credit card market serves people with credit scores of 660 or less.[b]

[a] "Subprime Lending, Expanded Guidance for Subprime Lending Programs," http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf.
[b] See "Understanding Your Credit Score," http://www.fairisaac.com/NR/rdonlyres/DA689E4A-08E8-42C7-9DD0-1D87FA6ED726/0/UnderstandCreditScoreBklt.pdf; and Vikki Frank, "Helping Clients Build Credit," *Communities & Banking* 18, no. 4 (fall 2007).

debtors will repay their credit card debt even after they seek bankruptcy protection. To assess just how likely, the risk-assessment company Fair Isaac has developed a FICO Bankruptcy Risk Score that "rank-orders consumers according to the likely bankruptcy loss ratio (bankruptcy losses divided by revenue) each consumer represents to a credit grantor."[9]

This dynamic may at least partly explain the increase in solicitations to subprime borrowers. Observers have also noted that because home values are decreasing and offer less equity to tap, borrowers who do not have enough money to pay both their mortgage and their credit card bill may be more willing to pay the latter. Borrowers are beginning to reason that because they owe more than the house is worth, it is better to maintain an easy source of credit than to keep a house that they cannot afford anyway.

However, if housing pressures continue to plague the economy or if the nation enters a recession, subprime borrowers may begin to have trouble even if they make credit card payments in a timely manner. Credit card companies that consider these borrowers a delinquency risk may exercise their right under the card agreement to increase interest rates, reduce the credit limit, or close a consumer account entirely, which would further deteriorate a subprime customer's credit score and cause other card issuers to take similar steps. Thus, while credit cards are a valuable financial tool, consumers must understand their card agreements so that they are aware of all the ramifications of credit card usage.

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Endnotes

1 These statistics represent seasonally adjusted delinquincies for the 100 largest banks during the first quarter of 2007 and the first quarter of 2008, www.federalreserve.gov/releases/chargeoff/deltop100sa.htm

2 "Card Sharks: Is the Subprime Mortgage Crisis Infecting America's Credit Card Market?" *The Economist*, November 29, 2007, www.economist.com/finance/printerfriendly.cfm?story_id=10229961.

3 "Industry Outlook Darkens after Amex's Warning," American Banker, January 14, 2008, www.americanbanker.com/printthis.html?id=20080111UKTBCZ0Q.

4 Robert Gavin, "Card Companies Woo Struggling Mortgage-Holders," *Boston Globe*, September 4, 2007; and Liz Pulliam Weston, "Let's Punish Lenders of Easy Credit," Dec 6, 2007, http://articles.moneycentral.msn.com/Banking/CreditCardSmarts/LetsPunishLendersOfEasyCredit.aspx.

5 "Credit Cards, Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers" (GAO-06-929, U.S. Government Accountability Office, Washington, DC, September 2006).

6 "Fee Harvesters: Low-Credit, High-Cost Cards Bleed Consumers" (Washington, DC: National Consumer Law Center, November 2007), p. 6. For numerous examples of credit cards targeted to people with bad credit, see http://www.creditcards.com/bad-credit.php.

7 The Federal Reserve has proposed changes to section of Regulation Z, which implements the Truth-in-Lending Act, impacting open-end credit disclosures, particularly credit card disclosures. Changes to Regulation AA, which prohibits unfair and deceptive practices by banks, are also expected.

8 "Proposed Rules," *Federal Register* 72, no. 114 (June 14, 2007).

9 See http://www.fairisaac.com/fic/en/product-service/product-index/credit-bureau-bankruptcy-scores.