OVER THE LIMIT

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Illustrations by Max Miceli

Americans accustomed to cheap and easy money—and an economy geared to their free-spending ways—face a harsh new reality as banks raise rates and lower ceilings on credit cards

Life got more expensive for the Fitzgerald family when their daughter was born last year. So John, a bartender, and his wife, Adela Uchida, an anchor at a local TV station, sometimes used credit cards to charge household expenses such as groceries or the taxes on their two-bedroom home in Lansing, Mich. That's not an option anymore, they say, because their bank hiked the rate on one card from 17% to 25%, while another cut their credit limit from $13,000 to $2,000. Now it's cash only for the couple, who worry about how they would deal with a financial emergency. "The economy here is not good," says Fitzgerald. "If something happened to me or my wife, we would never pay off these balances."

The credit crisis that began rumbling through the mortgage market last summer is now spilling over to the nation's other great expanse of borrowing: credit cards. Banks have extended $740 billion to Americans like the Fitzgeralds, a 15% jump over the past five years. With the economy weakening, delinquencies are rising, particularly in states battered by the housing bust.

The casualties are piling up. Profits at Citigroup's U.S. card division dropped 53% in the fourth quarter from the third. JPMorgan Chase reported in the latest period a 40% year-over-year jump in credit-card costs, to $1.8 billion. At American Express provisions for loan losses rose 70%, to $1.5 billion, a sign that even the well-heeled may be feeling the pinch. "Every day we obsess [over] how bad could it get," Richard D. Fairbank, CEO of one of the largest card issuers, Capital One, told analysts on Jan. 23. He also conceded that the nearly $2 billion it has set aside for loan losses may not be enough. "The real answer is: Nobody knows."

Banks and other card issuers are lowering credit limits, hiking interest rates, and refusing to approve applications as part of a broad clampdown to prevent more losses. That leaves strapped consumers with few options. Homeowners can no longer turn their equity into cash to pay their bills. Tough bankruptcy laws passed in 2005 narrowed another avenue of escape. So some desperate borrowers are resorting to more perilous measures: raiding their retirement accounts and insurance plans and seeking loans from alternative credit sources such as payday lenders and pawnshops that extract a high price for the cash.

The roots of the problem can be traced to the mortgage mess. As housing values ballooned over the past decade, a warm feeling of financial security washed over borrowers, who jacked their cards up to the limit. After all, when they hit the ceiling, they could tap into their equity to pay down their balances. Between 2001 and 2006, borrowers cashed out some $1.2 trillion from their homes. As a result, the average debt-to-income ratio for middle-class Americans now stands at 141%, double what it was in 1983. "As home prices went up, consumers felt confident about purchasing all kinds of extravagant goods and services on their credit cards," says Ray Schimmel, a San Diego attor-


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ney who specializes in bankraptcy and mortgage defaults.

Now the trend hás reversed. The drop in home prices hás wiped out billions in equity, and since families can no longer use their abodes as ATMs, debt loads are mounting and borrowers are falling behin.d on payments. At the Consumer Credit Counseling Service of San Francisco, the average balance of those seeking help hás jumped from $14,000 to $27,000 over the past year, with more people turning to piastic for everyday items. From here, "any kind of perturbation will cause families to go into financial shock," says Edward N. Wolff, an economics professor at New York University.

If that happens, it could set off a chain reaction, with consumer losses crippling lenders and infecting the markets that the banks depend on to finance credit-card lending. As with mortgages, banks bundle big chunks of so-called credit-card receivables,essentiallyconsumers'outstandingloan balances. Then they issue bonds backed by the bundles, which are sold to big investors such as pensions and mutual funds.

ADOUBLESQUEEZE

Credit-card securities are a different breed from those financing housing. For one thing, credit-card debt is unsecured. That means if a borrower defaults, there's no tangible asset, such as a house, that can be sold to recoup at least some of the money. And if delinquencies and defaults double or triple from current leveis, investors will likely realize losses. If that happens, it will cost banks more to securitize the credit-card debt, and they will have to set aside more capital on their books. Ali that translates into another hit to earnings. "You have banks being squeezed from both mortgage and credit-card securities," says Kareem M. Serageldin, global head of collateralized debt obligations at Credit Suisse Group.

There are already signs of weakness. The consultancy RiskMetrics recently analyzed 14 large pools of credit-card assets and found that delinquencies and bad loans had jumped by as much as 19% in the last six months of 2007. Among the worst securities by December: those issued by Capital One, London-based HSBC, and General Electric. "HSBC hás experiencedhigher delinquencies due to receivable growth, mix changes, portfolio seasoning, and an increase in bankruptcy filings," an HSBC spokeswoman said. Capital One and GE declined to comment.

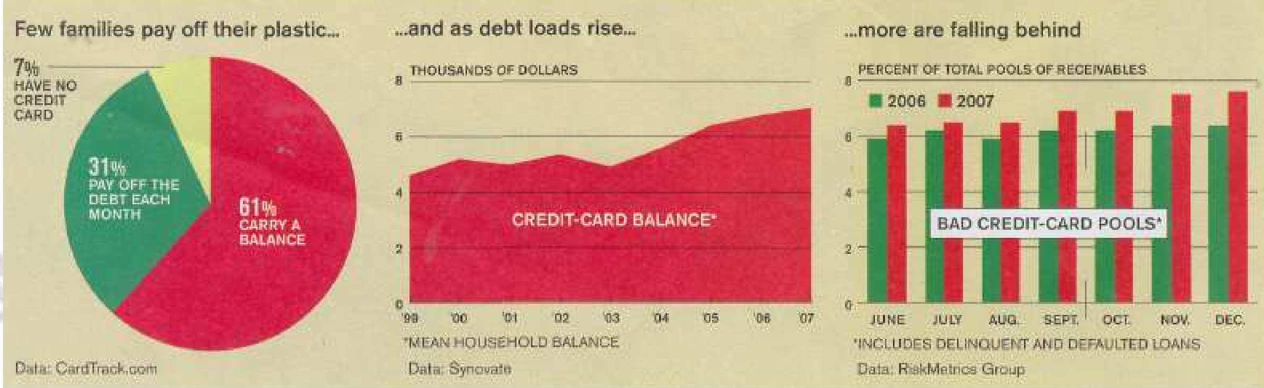
BUSINESSWEEK TV | For more on the credit crunch, particularly the tightening of home equity loans, watch our weekly show, *BusinessWeek TV*. To see video clips or find your local station and airtime by Zip Code, go to BusinessweekTV.com.

The problems in credit cards aren't likely to be as heart-stopping as those in mortgages, where underwriting standards were thrown out the window. Defaults on consumer loans remain below the leveis seen in the recessions of the early 19905 and 2001. Thafs partly because banks flushed out some of their worst card debt in 2005 when consumers flooded the courts to file for bankruptcy before new rules took effect, making it difficult for troubled borrowers to completely wipe out their debt. Then there's the gravitas of the industry: The top 10 card issuers, which account for 95% of the market for credit-card securities, are ali big, highly rated banks. By moving quickly to cut off risky card users early, the big banks are hoping to keep the crunch from developing into a crisis.

What happens to consumers? Nobody really knows, since the U.S. hasn't faced a credit crunch of this magnitude in 25 years. Certainly, many will try to live within their means. Others with decent credit will seek different sources of cash such as new peer-to-peer lenders, which let ordinary people act as bankers, making loans over the Internet to borrowers. When 3l-year-old Teejo Pallayi couldn't easily get a loan to pay off his high-interest credit cards, the New York software systems manager turned to one such outfit, Lending Club. He qualified for a $10,000 loan at 9.6%, far less than the 12% Citibank offered him. "I was able to say goodbye to those cards," says Pallayi. .

MAXED OUT

The crisis that started in the mortgage market is spreading to credit cards



Data: CardTrack.com

*MEAN HOUSEHOLD BALANCE
Data: Synovate

*INCLUDES DELINQUENT AND DEFAULTED LOANS
Data: RiskMetrics Group

Inevitably, though, shutting off the flow of easy money will hurt some consumers, as it did yo-year-old Mary Greenleaf of North Cape May, N.J. The retiredbuilding manager relied on credit cards to supplement her $8oo-a-month income from Social Security, charging purchases at drugstores and supermarkets. But her bank raised her rate from 17% to 29% in September, boosting her minimum monthly payments. She hás since curbed her spending and moved in with her daughter. "I haven't been to the doctor, since I don't have money for the co-pays," she says. But the belt-tightening hasn't been enough. In recent months, Greenleaf hás borrowed $3,000 against her $40,000 life insurance policy. If she falls behind onherpremiums—increasinglylikely,givenherdirefinancial straits—she will have to pay income taxes on the loan as well as on the gains built up over the years. "I wanted to leave my kids with something," she laments.

FRINGELENDERS

Money manager Fidelity Investments hás seen a big spike in the past year in só-called hardship withdrawals from 40i(k)s for medicai bills, college tuition, and the like. The price is steep:a$lo,ooo40l(k)withdrawalcostsaround$3,8oo,assuming a 28% tax rate and a 10% penalty for tapping funds early. Plus, there's the loss of potential investment gains.

Plenty are profiting from the financial wreckage. Banks are increasingly pushing secured credit cards, which require borrowers to put down a deposit and charge stiff 19%-plus rates. CompuCredit, which specializes in cards for consumers with poor credit, added 500,000 accounts in the third quarter. Collection agencies, too, have moved into the credit-card game: PRM Financial Services offers debtors a card at a fixed rate of 18.9%. "We're talking to doctors, attorneys, and businesspeople," says Carol Freeland, a partner at PRM Financial. "Just because you make a lot of money doesn't mean you don't end up in trouble."

That may be why payday lenders, which advance customers money on their paychecks at rates of up to 500%, are migrating to more affluent neighborhoods. According to a recent Brookings Institution study, there were only a few hundred payday lenders in the U.S. in the 19905; now there are more than 23,000, with 37% located in Zip Codes where the median income is at least $48,000. "People who never dreamed they'd go to a payday lender are going," says Gail Cunningham of the nonprofit National Foundation for Credit Counseling.

Despite attempts by some state regulators to rein in payday and other high-rate lenders, the business is better than ever. Pawnshop operator EZcorp reported on Jan. 24 that earnings in the latest quarter had jumped 29%, while payday lender Cash America International announced the same day that profits climbed 21%. Shares of EZcorp are up 20% this year. Another sign of the dismal times: The Game Show Network is developing a program called *Pay It Back*, where contestants win money to pay off their debts.

The downturn may be the start of a vicious cycle. As the housing market tumbles, more households slide into financial peril. Banks pull back credit even further, sending consumers into the arms of higher-cost lenders. Says Stifel Nicolaus bank analyst Christopher Brendler: "We're in unchartedterritory." i BW i

-WithEmily ThorntoninNew York

LINKS

Help or Harm?

The debate over payday lenders rages on. Three studies have conflicting views, wrote the *Daily Press* in Newport, Va., on Dec. 13. The Federal Reserve Bank of New York and the Center for Responsible Lending found that curbing the practice doesn't help borrowers' debt burden. Both said consumers in states such as Georgia and North Carolina bounced more checks and complained more about debt collectors after payday lenders were banned there. Yet in a University of North Carolina study, hundreds of borrowers said they were better off without these lenders.

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