the new squeeze

how a perfect storm of bad mortgages and credit card debt could paralyze the recovery

José García

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Dēmos is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world.

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EXECUTIVE SUMMARY

The fallout from sub-prime mortgage speculation and overly aggressive Adjustable Rate Mortgages (ARMs) will impact the United States economy well into the future—as we watch large financial firms continue to collapse and feel the aftershocks within the stock market. For the average consumer, at the household level, the impact of the financial market meltdown is deep and could be long-lasting: With less capital flowing through the nation's lending market, access to credit is dwindling, a condition that could ultimately prevent a vital recovery in the housing, consumer, capital investment and business sectors. A report from the International Monetary Fund (IMF) estimates that U.S. losses from loans and securitized assets are likely to increase to about $1.4 trillion; based on that analysis, we are only half way there.[1]

In 2008, over $250 billion worth of mortgages will reset with another $700 billion dollars expected to reset by 2010. While the recent rescue bill helped to address Wall Street's financial woes, it did not provide direct assistance to homeowners who have been foreclosed on in record numbers—one of the underlying causes of the credit crunch.

Credit has become more costly to consumers as the lending industry rethinks its reckless lending practices. Nearly all consumers have been affected by the lack of liquidity of consumer lending products which many use to deal with economic difficulties.

Mortgages:

- Areas hard-hit by foreclosures may require 20 percent or 25 percent down payment, moving away from no document and no to low down payment mortgages which flooded the market prior to the meltdown, but far higher that the standard 10 percent downpayment that was commonly required before the sub-prime and APR loan boom.
- Cost of private mortgage insurance increased 50 percent from .5 percent of home price to .75 percent.

Home Equity:

- According to the Senior Loan Officer Opinion Survey, 75 percent of respondents said that they have tightened standards for approving revolving home equity lines of credit.
- Some lenders are blocking home equity loan holders from selling or refinancing their home until they have repaid part or the entirety of their loan.

Credit Cards:

- Among domestic banks, 58 percent report that they have tightened their lending standards on credit card loans in October 2008.
- Consumers are experiencing higher interest rates, lower credit limits, increased fees and penalties, and tightened restrictions on new credit applicants.

Student Loans:

- ▹ Private student loan interest rates have increased by nearly a percentage point since October 2007.
- ▹ Lenders are requiring credit scores near 700, as opposed to 600, to qualify for private student loans, a change that affects more than 200,000 student borrowers.

Small Business Loans

- ▹ Nearly 75 percent of domestic banks have tightened lending standards for commercial and industrial loans.
- ▹ According to the National Small Business Association, credit card usage increased 28 percentage points from 16 percent to 44 percent in 2008, while bank loans decreased from 45 percent to 28 percent among small businesses.

Leading economic indicators continue to portend difficult times for American households in the form of higher unemployment, rising fuel and food prices, low savings rates and stagnant incomes. With the lending market constricted, credit—which families have increasingly relied on to get by—may not be there to help American households from falling into financial insolvency as they struggle to survive on stagnant incomes, increasing costs of living and limited financial safety nets.

INTRODUCTION

As the collapse of Wall Street institutions continues, it's easy to forget that the origins of the fiscal meltdown began with the aggressive marketing of sub-prime mortgages, particularly the adjustable-rate variety, to homeowners desperate for cash or speculators gambling on ever-rising home values. With our nation's leaders working to restore investor confidence in the markets by focusing on the banking system, it is Main Street that will continue to suffer the economic consequences of the failed experiment of deregulation that fueled the proliferation of irresponsible and predatory lending vehicles, the trading of mortgage-backed securities, and other wall street concoctions that assisted the financing of these unsustainable mortgage products. Families face mounting job losses, shrinking paychecks and increased foreclosures as well as a constrained credit market that makes it harder for consumers to borrow for essential expenditures. According to the Federal Reserve, consumer borrowing declined by \$7.9 billion in August 2008—the biggest monthly drop in more than 50 years.[2]

To stave off a financial crisis, the Federal government passed a \$700 billion bailout plan in an effort to restore liquidity to an economy drowning in bad debt. The bill included some marginal help for consumers: tax breaks for small businesses, promotion of renewable energy, an increase in FDIC insurance to \$250,000, expansion of the child tax credit, and help for victims of recent natural disasters.[3] However, the bulk of the money will go to buying mortgage-backed securities from financial firms and purchasing stocks in those firms (so far to the tune of \$250 billion), which helps their share price but not consumers directly. Legislators hope that with bad assets off the books, banks will start lending again and the credit markets will open up. Despite the bailout the Dow has continued to fall, exposing investors' weariness and calling into question the ability of consumers to access credit when needed.

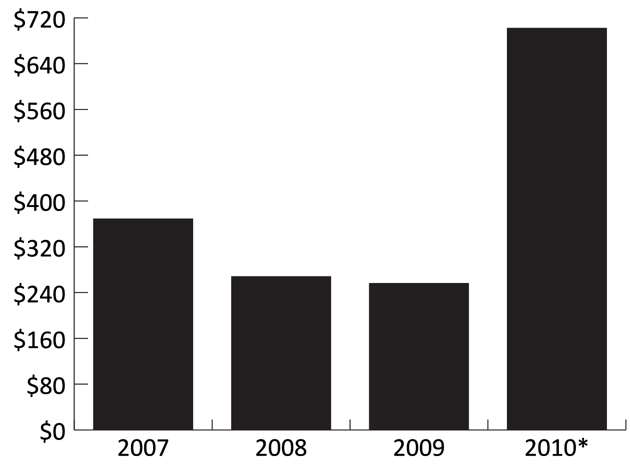
This paper examines how the turmoil in the nation's financial sector, particularly in the mortgage markets, is impacting the availability and cost of other types of credit.

MORE TOXIC MORTGAGES WAITING TO EXPLODE

U.S. losses from loans and securitized assets are likely to increase to about $1.4 trillion—pointing towards greater write-offs as financial institutions experience record losses.[4] JP Morgan Chase saw an increase in charge-offs—credits that were previously carried as receivables, but are now considered uncollectable—from .05 percent to .95 percent between the second quarter 2007 and 2008. By mid-2008, Citigroup reported $3.4 billion in charge-off losses from sub-prime loan products.[5]

These losses will only increase as more sub-prime adjustable mortgages reset over the next couple of years. More than $250 billion worth of mortgages will reset in 2008 and 2009 with another $700 billion expected in 2010 and beyond (See Chart 1).[6] Unfortunately, the bulk of these loans are at risk of default as homeowners face higher mortgage payments as their loans reset under the new rate. While the recent bailout bill helped to address Wall Street's financial problems, it did not provide direct assistance to homeowners who have been foreclosed on in record numbers—one of the underlying causes of the credit crunch.

Chart 1. Adjustable Rate Mortgage Reset Schedule: More to Come
1st Mortgages Originated in 2004 – 2006 (in billions)



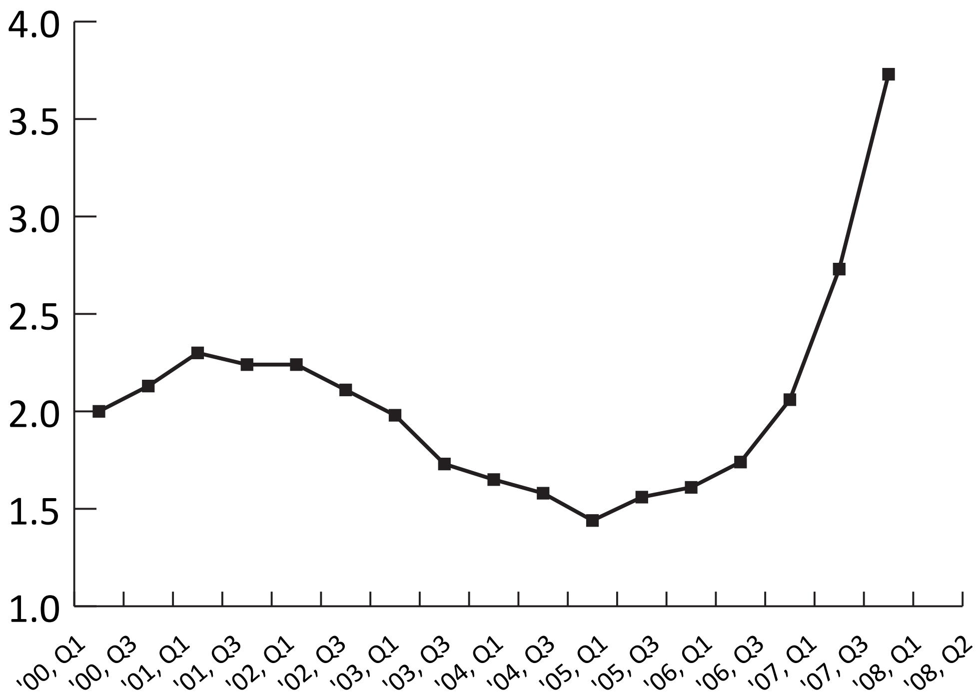
Source: First American CoreLogic/C. Cagan

***2010 and beyond**

The write-offs have spurred lenders to adjust their business practices by tightening underwriting and increasing borrower costs. The good news is that dangerous products like so-called "liars loans" (where borrowers do not provide detailed proof of income or assets) have been pulled from the market. Requirements for down payments have returned to normal levels for some with well-established credit history, with J.P. Morgan Chase, for example, now requiring at least a 10 percent down payment. But for aspiring first-time buyers in areas hit hardest by foreclosures, such as Reno, Nevada, down payment requirements may be too steep—with some lenders requiring down payments of 20 to 25 percent.[7] In addition, first-time homebuyers with less than 20 percent down will pay higher costs for private mortgage insurance (PMI). In the past, PMI totalled .5 percent of the amount financed but now mortgage lenders may require .75 percent.[8]

HOME EQUITY LENDING DRIES UP

Chart 2. Residential Real Estate Delinquency Rate, 2000 – 2008 (Second Quarter)



Source: Federal Reserve Bank, Charge-off and Delinquency Rates

Residential real estate loans include loans secured by one- to four-family properties, including home equity lines of credit.

Prior to the mortgage meltdown, homeowners capitalized on rapidly increasing home values by borrowing against the equity in their home. Between 2001 and 2007, home equity cashed out through refinancing totaled $1.4 trillion dollars.[9] During the same period of time home equity loans totaled $1.2 trillion dollars.[10] Now, however, as losses accumulate, many lenders are freezing existing home equity lines and are no longer making new loans.

The Federal Reserve has found that delinquencies of residential real estate loans, including home equity lines of credit, have jumped 299 *basis points* (a unit measured as 1/100th of a percentage point) since 2005—when the delinquency rate was 1.34 in the first quarter compared to 4.33 percent in the second quarter of 2008 (see Chart 2).[11]

As delinquencies and defaults rise, so are lending institutions' loss claims. FDIC insured banks' net charge-offs increased 632.7 percent between the second quarter of 2007 and 2008.[12] In the second quarter of 2008, net charge-offs of home equity lines of credit were $2.8 billion.[13] For JPMorgan Chase & Co, losses from failed home-equity loans reached $450 million in the first quarter and doubled to $900 million by the fourth quarter of 2007.[14] And United Services Automobile Association USAA), a financial institution, has frozen or reduced some 15,000 home equity lines of credit.[15]

With shrinking capital, lenders have reduced the availability of home equity lines of credit by 40 percent, and decreased loan amounts available to borrowers.[16] According to the Senior Loan Officer Opinion Survey, 75 percent of respondents said that they have tightened standards for approving revolving home equity lines of credit.[17] The FDIC reported that in the first quarter of 2008 home equity lines of credit have fallen 1.4 percent to $10.3 billion among FDIC-insured financial institutions.[18] In anticipation of escalating write-downs, lenders are introducing stringent lending and loan-qualification practices. Some homeowners who took out home equity loans during the boom are finding that their lenders are blocking them from selling or refinancing their home until they have repaid part or the entirety of their loan[19]. By blocking their ability to refinance, many homeowners are left unable to change the terms of their adjustable rate mortgages—thereby increasing the possibility of foreclosure. For those homeowners close to foreclosure, mortgage lenders have been negotiating with home equity lenders for a percentage of the sale to be applied to second lines of credit. When the first and second lien lender is the same institution, lenders have been increasingly writing off the home equity loan as a loss in order to increase the likelihood of mortgage debt repayment[20].

Banks are taking such aggressive steps to prevent further losses in this market because the funds are difficult to recover if the homeowner defaults, making it difficult for financial institutions to meet expected pay outs. Since first liens take priority in the foreclosure process, an equity loan will only be repaid after the initial mortgage. If they are issued by different lenders, there is no incentive for the mortgage originator to assist the second line lender in receiving payment.[21] And with falling home prices, the sale of the home may not cover all or part of the home equity loan.

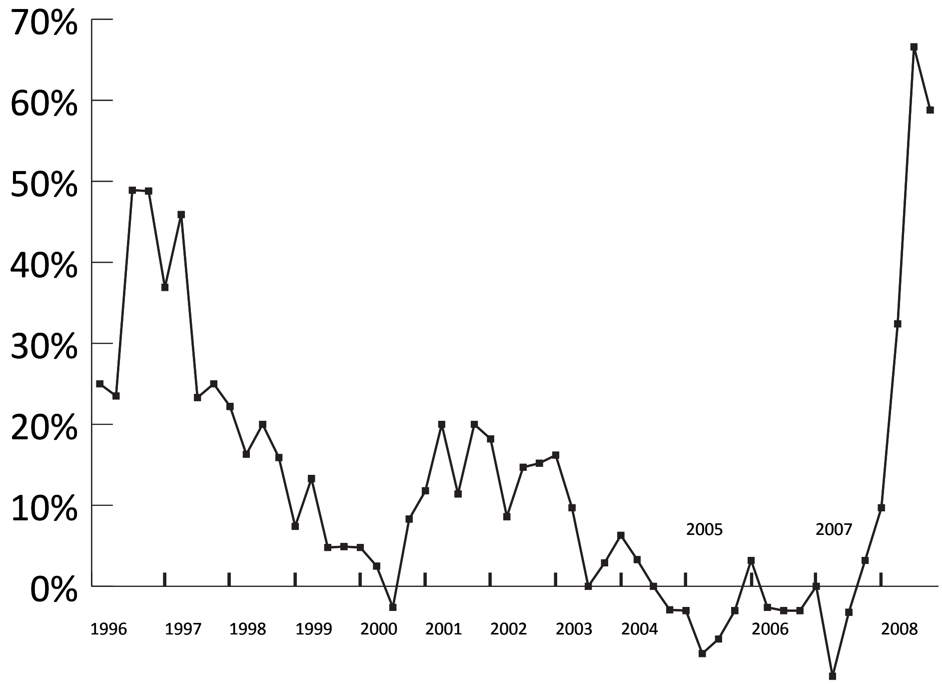
With access to home equity loans or lines of credit drying up, households have begun increasing their credit card debt.

CREDIT CARD DEBT GROWS AMIDST MORTGAGE MELTDOWN

Aggregate revolving debt totaled $966 billion in the second quarter of 2008—20 percent higher when compared to 2003.[28] With little or no home equity to tap for emergency expenses or to deal with rising costs, consumers have turned to their credit cards to make ends meet. Nervous investors, who fear a collapse in the credit card market, have decreased their investments in credit card backed securities—an eerily similar development when compared to the downturn in bundled mortgage securities investment following the meltdown.

Delinquencies on credit card accounts have risen from around 4.1 percent in the second quarter of 2007 to 4.9 percent in the second quarter of 2008—the highest rate since the second quarter of 2002.[29] Charge-offs have climbed to 5.47 percent in the second quarter of 2008, up from 3.52 percent in the second quarter of 2006.[30] Bank of America, which manages 20 percent of the national credit card market, has a 184 billion dollar credit card portfolio which suffers a 5.19 percent annual rate loss, or approximately $2.5 billion in the first quarter of 2008.[31] With this trend expected to continue, companies are looking to control risk and recuperate losses.[32] Existing cardholders have seen their credit lines decreased, putting many consumers closer to maxing out their credit limit, which could result in over-the-credit-limit fees and negatively impact their credit score. These industry protection techniques may be counterproductive in decreasing charge-offs as consumers experience increased financial strain. The alternative could be to lower rates and fees on credit card debt for consumers, which could help decrease charge-offs.

Chart 3. Domestic Banks Tightening Credit Card Standards



Source: Federal Reserve, "Senior Loan Officer Opinion Survey on Bank lending Practices," October 2008

In a October 2008 Federal Reserve survey, approximately 58.8 percent of domestic banks had tightened underwriting on credit card loans over the previous three months.[33] (see Chart 3) In addition to closing off access to credit, issuers are also responding to tightened capital and rising losses by raising interest rates and fees. According to *Bankrate.com*, as of the second quarter of 2008 the average interest rate for a standard fixed-rate credit card was **13.42 percent and 11.57 percent APR for a standard variable-rate card.** On April 29, 2008, *USA Today* reported that Washington Mutual was raising some credit card rates 100 percent.[34] Bank of America reported tripling some of their cardholder's rates to 28 percent.[35] CEO Ken Lewis, on a January 22, 2008, conference call, explained why: "We're focused on getting paid for the risk we take."[36] This type of industry thinking may potentially lead to more risk down the line as credit card companies seek to increase profits.

Interest rates for the Chase Freedom variable rate credit card rose 3 percentage points from 14.24 percent in September 2007 to 17.24 percent in January 2008.[37] The purchase APR on the Blue card from American Express went from 12.24 percent in September 2007 to 11.74 percent in October 2007 but has climbed back to 12.24 percent in March 2008.[38] Discover Card is increasing its credit card penalty rate to 31 percent. According to a February 2008 report in the *Wall Street Journal*, revenue from credit card fees increased from $17.1 billion in 2006 to $18.1 billion in 2007, a 5 percent increase.[39]

Finally, in an effort to reduce their losses, some credit card companies are selling their delinquent accounts to third party debt collectors, which lowers their costs of servicing the debt. While this helps banks to recuperate a portion of their charge-offs, consumers can be exposed to aggressive and often abusive tactics of collection agencies.[40]

Credit Card Securitization: Watch it!

As credit card lending grew dramatically over the last decade, securitization has increasingly provided funding for the credit card industry. Differing from mortgage, auto, student and home equity loans which typically have a predetermined term (eg. five, 10 or 30 years) for repayment, credit card loans can be paid at any moment in time with the ability to add to the total owed as long as minimum monthly payments are maintained and spending is below the credit limit.[22] For that reason, credit cards are considered unsecured debt—and unlike a mortgage are not tied to any collateral.[23]

Rather, the money owed by a cardholder acts as an asset that sits on a bank's balance sheet as a "receivable." Lenders, however, need to move credit card debt off their balance sheets in order to free up money for additional lending. Banks do this by selling a percentage of their credit card accounts to a special trust set up by the credit card bank. The bank then bundles together millions of credit card accounts with the money owed by cardholders acting as an asset. As cardholders could take months or years to repay, the bank sells the future credit card payments to the securitized trusts which then sell an interest in the future assets to investors. The securitization process provides credit card lenders with a steady flow of capital to provide credit as well as issue new credit cards.

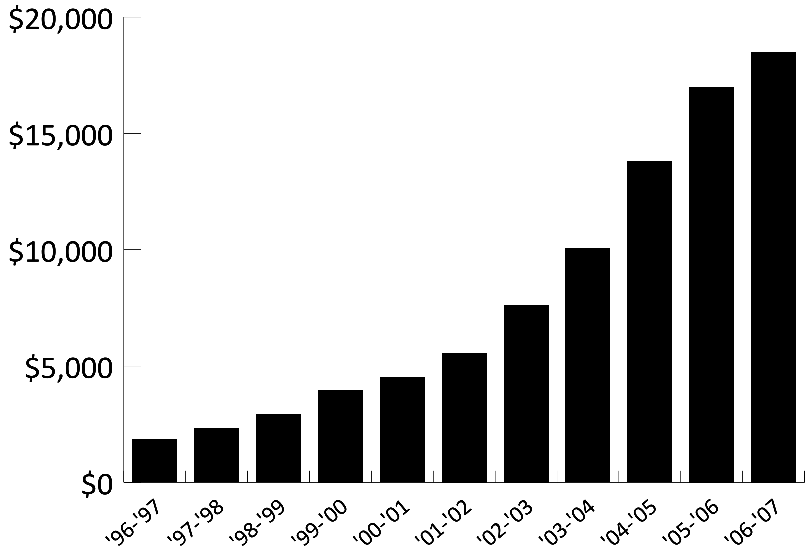
Following the collapse of the sub-prime market, credit card profits from the interest revenue on revolving balances from fees hovered at 17.4 percent, which was 144 basis points lower than the average in 2007.[24] While it would appear that the credit card industry experienced massive losses, the industry's cost of funds decreased 250 basis points compared to the average in 2007.[25] The decrease in cost of funds helped to offset the decreasing revenue since it cost lenders less to provide credit.[26] This allowed the credit card industry to still maintain some gains as many other areas of Wall Street experienced losses.[27]

However, as unemployment and underemployment chips away at the financial solvency of American families, delinquencies and defaults on credit card accounts will continue to increase, forcing banks to write off more losses and calling into question the sustainability of the credit card securitization process.

PRIVATE STUDENT LOANS GET PRICIER

Faced with rising tuition costs, more students are turning to private student loans—those loans that are not made through the federal student loan program—to help pay for college. Over the past decade private student loan volume has grown an astounding 894 percent to $77 billion, accounting for nearly a quarter of all student loans.[41] Today about 9 million students, or 10 percent of all post secondary students, take out private student loans to assist them in funding their continued education.[42] Unlike federal student loans which have a fixed interest rate of 6.8 percent, private student loans are typically variable rate loans, with higher starting interest rates and costly origination fees. It is not unheard of for a private student loan to carry a 10 percent interest rate, and origination fees can vary from 2.8 percent to 9.9 percent, with an average of 4.5 percent.[43] According to FinancialAid.org, some private student loans will reset from a current 10 to 11 percent range to as high as 12 to 14 percent.[44]

Chart 4. Private Student Loans Used to Finance Undergraduate Postsecondary Education Expenses in Constant (2006) Dollars (in $ Millions), 1996-97 to 2006-07



Source: College Board, Trends in Financial Aid, 2007

The private student loan market, which has also suffered liquidity constraints due to nervous investors, has been further affected from tightened underwriting requirements. Before the meltdown, most student borrowers with credit scores higher than 600 could qualify for private loans. As a result of the credit crunch, most lenders are requiring credit scores closer to 700 to qualify, which has affected more than 200,000 borrowers in need of private student loans.[45] Low-income students attending 2-year career colleges, technical colleges and for-profit institutions are the most affected by the changing standards.

Several lenders have left the private student loan market all together. The Education Resources Institute (TERI), which insures over $17 billion in privately issued student loans, filed for Chapter 11 bankruptcy protection, causing shares of First Marblehead Corp, one of the largest securitizers of student loans, to drop from $40 to $2.95 a share. Bank of America, which lent $900 million in private student loans during the 2007 school year, has since stopped making private student loans.[46]

Currently, 150 private student lenders have stopped making private student loans.[47] For example, the Massachusetts Educational Financing Authority, a non-profit self-financing state authority which does not rely on state or federal appropriations, has been unable to provide private student loans to college students in 2008 as a result of their inability to secure financing from the capital markets, resulting in more than 40,000 college students unable to service loans.[48] To ensure that students would be able to access federal student loans, in April 2008, Congress passed the Ensuring Continued Access to Student Loans Act. This law provides the U.S. Department of Education with the temporary authority to buy Federal Family Education Loans and ensure access to federal subsidies. As a result of the continued credit crunch, the Act was extended until 2010 in an effort to bolster the student lending market.

SMALL BUSINESS LOANS

The ability to access funds is integral to the start-up and survival of small businesses, particularly during economic downturns. Yet, around 74.5 percent of domestic banks have tightened lending standards for commercial and industrial loans for small firms .[49] From requiring higher credit scores to increases in premiums, business owners report that accessing a commercial loan requires more paper work, more collateral in the form of accounts receivable, inventory equipment and/or real estate as well as more time to acquire the loan if at all.[50] Often these small business owners use their home as collateral, but as home prices decrease and equity shrinks, along with equity even that may not be enough to satisfy lenders.

As access to small business loans has become tighter, many owners are using credit cards as a substitute. According to the National Small Business Association, credit card usage increased 28 percentage points from 16 percent to 44 percent in 2008, while bank loans decreased from 45 percent to 28 percent among small businesses.[51] As a result, today roughly 20 to 30 percent of small businesses have credit card debt.[52] Small business owners face the same increased costs experienced by consumers in the credit card market, but may be more financially vulnerable because they tend to carry higher balances and pay higher interest rates.

The inability of small businesses to acquire loans can impede the recovery of the larger economy. In February 2008, Senator John Kerry (D-Mass.), Chairman of the Committee on Small Business and Entrepreneurship, stated that "the mortgage crisis that is forcing hundreds of thousands of families to sell their homes or face foreclosure is now preventing many small businesspeople from getting the financing necessary to start or grow their businesses. Yet, investment in small business can assist growth since for every $33,000 loaned, one job is created or retained."

THE NEW OLD LOAN SHARKS

As credit has become harder to access from traditional lenders, alternative sources such as payday lending, pawn shops, auto title loans and other high-cost forms of credit are experiencing growth.

From 2006 to 2007, Cash America International, a large nationwide pawn shop, check cashing and payday loan company, reported revenue increases of 34 percent, from $693.2 million dollars in 2006 to $929.4 million dollars in 2007.[53] President of Cash America Daniel R. Feeham stated that in the second quarter of 2008 their pawn shop loans were particularly strong thanks to the tax stimulus payments.[54] EZ CORP, which provides pay day loans and pawn services, had net income in the third quarter of 2008 60 percent higher than in the third quarter of 2007. In addition, total revenues for that quarter increased 24 percent over the prior year, with pawn services up 34 percent, total sales (merchandise and jewelry scrapping) up 26 percent, and signature loan revenues (payday loan and credit service fees) up 16 percent.[55] The growth of the unregulated lending industry will only increase as consumers face higher costs for accessing credit.

CONCLUSION

The lack of liquidity in the credit markets has impacted consumers in a variety of ways, resulting in credit that is both harder to obtain and more costly. Despite the federal government's bailout plan, it is unclear how long it will take to ease nervous investors and improve liquidity in the nation's credit markets. The hard learned lesson from the recent turmoil is the need to create accountability within the lending industry—from mortgage brokers to the companies that rate securities. Broader industry regulations are needed to address the securitization of debt which allowed mortgage backed securities to crash and resulted in a credit crunch that required the injection of $700 billion of taxpayers' money into the US economy.

Leading economic indicators continue to portend difficult times for American households in the form of higher unemployment, rising gas and food prices, and stagnant incomes. With the lending market constricted, credit—which families have increasingly relied on to get by—may not be there to help American households from falling into financial insolvency as they struggle to survive on stagnant incomes, increasing costs of living and limited financial safety nets.

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Up to Our Eyeballs: How Shady Lenders and Failed Economic Policies Are Drowning Americans in Debt, By José García, James Lardner & Cindy Zeldin (The New Press, April 2008)

Strapped: Why America's 20- and 30-Somethings Can't Get Ahead, By Tamara Draut (Doubleday, January 2006)

Inequality Matters: The Growing Economic Divide in America and Its Poisonous Consequences, Edited By James Lardner & David A. Smith (The New Press, January 2006)

Falling Behind: How Rising Inequality Hurts the Middle Class, By Robert Frank (UC Press, July 2007)

The Squandering of America: How the Failure of Our Politics Undermines Our Prosperity, By Robert Kuttner (Vintage/Knopf, November 2008)

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