Credit Cards Are the Next Credit Crunch

By Eswar Prasad

Few doubt the importance of consumer spending to the U.S. economy, and its multiplier effect on the global economy, but what is under-appreciated is the role of credit cards in that spending. Currently, there is roughly $5 trillion in credit-card debt outstanding in the U.S., and a little more than $600 billion in credit-card premiums currently drawn upon. While those numbers look small relative to total U.S. debt, the $10.5 trillion, credit-card debt is revolving and accordingly being paid off and put back into the credit-card debt pool. A critical role in commerce in America. Just six months ago, I estimated that at least $2 trillion of available credit-card lines would be expunged from the system by the end of 2010. However, today, that estimate now looks optimistic, as available lines were reduced by nearly $500 billion in the first quarter. However, the revised estimates are that over $2 trillion of credit-card lines will be cut inside of 2009, and at least $2.7 trillion by the end of 2010. Inevitably, credit lines will continue to be reduced across the system, but the velocity of this is unlike anything since 2008. And in order to derail what I believe will be at least a 57% contraction in credit-card lines. There are several factors that are playing into this swift contraction in credit well beyond the scope of the current credit market disruption. First, the very foundation of credit-card lending over the past 15 years has been misguided. In order to facilitate global expansion and vast pools of consumer loans, lenders became overly reliant on risk metrics that turned out to be simply unreliable. Further, the bulk of credit lines were extended during a time when unemployment averaged well below 6%. Overly optimistic underwriting standards made more borrowers appear creditworthy. As we return to more realistic underwriting standards, certain borrowers will no longer appear worth the risk, and therefore lines will continue to be pulled from them. Second, home price depreciation has led to a more reliable determinant of consumer behavior than FICO scores. Hence, lenders have reduced credit lines based upon “zip codes,” or where home price depreciation has been most severe. Such a strategy carries the obvious hazard of putting good customers in more vulnerable liquidity positions simply because they live in a higher-risk zip code. With this, frequency of default is increased. In other words, as average credit-card balances are pulled and borrowing capacity is reduced, paying borrowers are pushed into vulnerable financial positions along with nonpaying borrowers, and therefore a greater risk-reduction in fact is cut.

Consumer behavior has become a more reliable determinant of the ability to pay. Second, such a negative spiral strategy necessitates immediate action. Currently five third-card lenders are currently playing a game of “hot potatoes,” in which no one wants the last one on holding an open credit-card line to an individual or business. While a mortgage loan is largely a “monogamous” relationship between borrower and lender, an individual’s multiple relationships with credit-card providers. Thus, as lines are cut, risk exposure increases to the remaining lenders, and therefore a greater risk-reduction in fact is cut.

Here, a negative spiral strategy necessitates immediate action. Currently five third-card lenders dominate two thirds of the credit card market. These lenders need to work together to protect one another and preserve credit lines to able paying borrowers by setting consortium guidelines on credit. We, as Americans, are all in the same soup here, and desperate times require radical and cooperative measures.

And fourth, along with many important and necessary mandates regarding fairness to consumers, impending changes to Unfair and Deceptive Acts or Practices (UDAP) regulations risk the very real unintended consequence of cutting off vast amounts of credit to consumers. Beneficial to the new UDAP guidelines would restrict repriming credit lines that risk, which could in turn restrict the availability of credit. If a lender cannot re-price for changing risk on an unsecured loan, the lender simply will make the loan. This proposal is set to be effective by mid-2010, but talk now is of accelerating its adoption date. Politicians and regulators need to seriously consider what unintended consequences could occur from the implementation of this proposal in current form. Short of the U.S. government becoming a direct credit-card lender, invariably credit will come out of the system.

Over the past 20 years, Americans have also grown to use their credit card as a cash-flow management tool. For example, the CFPB has found that consumer behavior has grown to be relied on as a source of liquidity and a management tool for many U.S. consumers. In fact, a relatively small portion of U.S. consumers have actually maxed out their credit cards, and most currently have ample room to spare on their unused credit limits. For example, the industry credit line utilization rate (or percentage of total credit line used) was at 36% in 2008, but dropped down to 25% by the end of 2008. However, this is in the process of changing dramatically. Without doubt credit was extended too freely over the past 15 years, and a return to much more prudent lending is unavoidable. What is avoidable, however, is taking credit away from people who have the ability to pay their bills. If credit is taken away from those who have paid their bills on time (and who have the ability to pay their bills) it becomes a serious mistake for any country to try to get themselves out of this crisis by following the same policies that have led us into this crisis in the first place.

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The Insurance Solution

By Meredith Whitney

We need a global solution for this collective problem. The best option is an insurance pool for the Group of 20 largest economies that would reduce incentives for lending at low standards. This would allow focus policy makers’ attention on the international consequences of individual countries’ actions. The insurance pool would function like a reserve fund, offering participants a short-term credit line they could call upon in the event of a crisis. In exchange for this “coverage,” each country would pay an entry fee. The entry fee would be $10 billion and $25 billion depending on its economic size. It would then pay an annual premium. The premium would depend on the level of insurance a country desired, and would average about 1% of the face value of the policy ($1 billion in annual premiums would secure, on average, access to a $100 billion credit line). But around that average level, the premium would also depend on the country’s economic policies. A country that chose to run large budget deficits or accumulate large amounts of debt would pay a higher premium. In essence, this sense that a country’s fiscal policy would be like car insurance, where owners of expensive cars or risky drivers pay more. The twist is that countries with policies that drive up global risks also face higher premiums. A country that decides that it still prefers to accumulate a large stock of foreign reserves to protect itself. That country could be charged a higher premium, which would serve as a disincentive to such policies. The premiums would also increase with the persistence and levels of policies that contributed to global risks. A country running large budget deficits or accumulating large stocks of reserves in successive years would pay rising premiums. Premiums would need to be based on simple rules. For instance, a current account balance (either deficit or surplus) larger than 2% of a country’s GDP could trigger a higher premium, with the premium amount also linked to the condition of the current account balance to take into account country size. This transparent, rules-based mechanism would strengthen moral suasion and force a country to at least partially internalize the effects of its own policies on global risks. The premiums would be invested in a portfolio of U.S., euro-area and Japanese government bonds. In return, those central banks would be obliged to tip up the pool’s lines of credit in the event of a global crisis. This would simply institutionalize swaps arrangements of the sort that the Federal Reserve and Bank of Japan recently opened up to provide liquidity to certain creditors. A country’s key point is that because this insurance pool would be smaller than the collective reserves it’s intended to replace, it wouldn’t contribute to the global imbalances the way current reserves often do.

Why would the world’s largest economies sign on to this program? Leaders could make it a condition for membership in the Financial Stability Forum, which has an important role in developing principles and financial regulations. This would also have the benefit of tying together financial and macroeconomic policies. The Forum could easily administer this insurance program. Economies outside the G-20 could also participate in this insurance pool, although that wouldn’t automatically guarantee Forum membership. Some also argued that the International Monetary Fund could provide such insurance if only it had more resources. But that’s politically unrealistic. Borrowing from the IMF carries a stigma and remains a toxic proposition for emerging-market politicians. The IMF is also unable to police effectively the macroeconomic policies of major countries. More resources for the IMF will not by itself solve the global macroeconomic problem. Only when emerging-market economies are presented with a viable alternative policy, the crisis will push them to accumulate even larger stocks of reserves to stay free of the IMF’s clutches, and inculcate themselves against volatile capital flows and attacks on their currencies. But self-insurance through reserve buildups is costly for emerging markets. Reserves tie up savings, which could be used to invest in, for example, investment, in low-yield, industrialized-coun- try government bonds. Moreover, large re- serve buildups could now seem but a memory in a future crisis.

The obvious question is clear: It would be a serious mistake for countries to try to get themselves out of this crisis by following the same policies that have led us into this crisis in the first place. But self-insurance through reserve buildups is costly for emerging markets. Reserves tie up savings, which could be used to invest in, for example, investment, in low-yield, industrialized-coun- try government bonds. Moreover, large re- serve buildups could now seem but a memory in a future crisis.

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