Credit Cards Are the Next Credit Crunch

By Meredith Whitney

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-card availability in that spending. Currently, there is roughly $5 trillion in credit-card lines outstanding in the U.S., and a little more than $800 billion is currently drawn upon. While those numbers look small relative to total mortgage debt of over $10.5 trillion, credit-card debt is revolving and accordingly being paid off and drawn down over and over, creating a critical role in commerce in America.

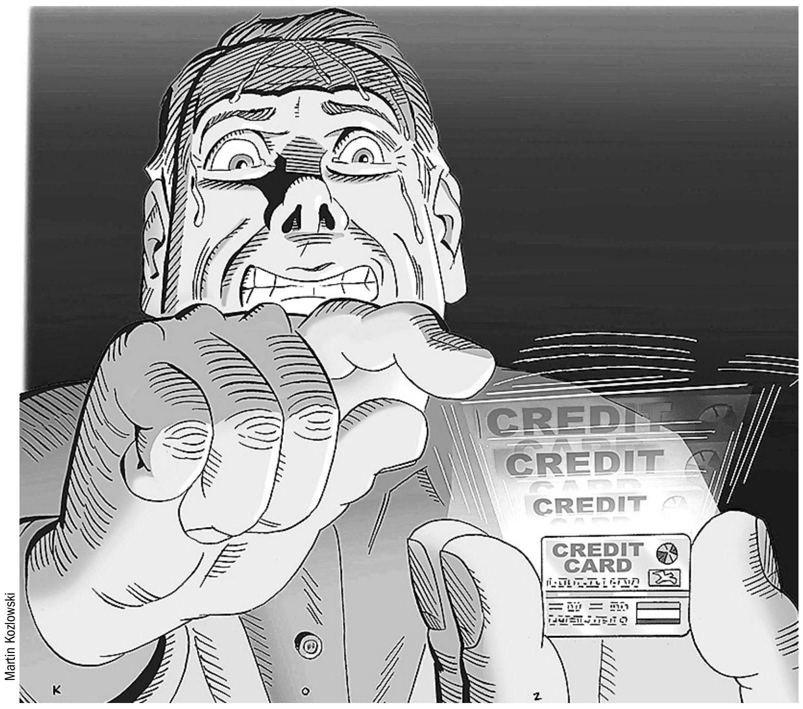
Washington risks making the problem even worse.

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 fourth quarter of 2008 alone. My revised estimates are that over $2 trillion of credit-card lines will be cut inside of 2009, and $2.7 trillion by the end of 2010.

Inevitably, credit lines will continue to be reduced across the system, but the velocity at which it is already occurring and will continue to occur will result in unintended consequences for consumer confidence, spending and the overall economy. Lenders, regulators and politicians need to show thoughtful leadership now on this issue 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 national expansion and vast pools of consumer loans, lenders became overly reliant on FICO scores that have borne 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 those borrowers.

Second, home price depreciation has been 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 acute. 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 lines are pulled and borrowing capacity is reduced, paying borrowers are pushed into vulnerable financial positions along with nonpaying borrowers, and therefore a greater number of defaults in fact occur.



Martin Kozlowski

Third, credit-card lenders are currently playing a game of “hot potato,” in which no one wants to be the last one 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 has multiple relationships with credit-card providers. Thus, as lines are cut, risk exposure increases to the remaining lender with the biggest line outstanding.

Here, such a negative spiral strategy necessitates immediate action. Currently five lenders dominate two thirds of the 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. Specifically, the new UDAP provisions would restrict repricing of risk, which could in turn restrict the availability of credit. If a lender cannot reprice for changing risk on an unsecured loan, the lender simply will not 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, 90% of credit-card users revolve a balance (i.e., don't pay it off in full) at least once a year, and over 45% of credit-card users revolve every month. Undeniably, consumers look at their unused credit balances as a “what if” reserve. “What if” my kid needs braces? “What if” my dog gets sick? “What if” I lose one of my jobs? This unused credit portion has grown to be relied on as a source of liquidity and a liquidity 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 lines. For example, the industry credit line utilization rate (or percentage of total credit lines outstanding drawn upon) was just 17% at 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 rationalization of 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 what otherwise is an able borrower, that borrower's financial position weakens considerably. With two-thirds of the U.S. economy dependent upon consumer spending, we should tread carefully and act collectively.

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The Insurance Solution

By Eswar Prasad

Everyone is now keenly aware of the imbalances that allowed the financial crisis to develop into a cataclysm. But governments are pursuing the same old policies that brought on the crisis in the first place, because no one has yet succeeded in giving countries incentives to take global financial stability into account when crafting their domestic policies. It's time for a new approach.

A global macroeconomic imbalance fanned the flames of the crisis. Low interest rates and excess consumption in the U.S. were exacerbated by excess savings in China and other emerging-market economies. The long-term solution is for those emerging economies to boost their own consumption. Right now, however, they're on track to do the opposite because they're focusing on short-term domestic benefits and ramping up efforts to boost exports, increase savings and enlarge foreign exchange reserves, which they pour into U.S. government bonds as a safe haven. Meanwhile, they're expecting U.S. consumption, in the form of a debt-fueled stimulus plan, to pull the global economy out of its slump.

We need a global solution for this collective action problem. The best option is an insurance pool for the Group of 20 largest economies that would reduce incentives for reserve buildups and help focus policy makers' attention on the international consequences of individual countries' actions.

Here's how it would work: 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 of between $10 billion and $25 billion, depending on its economic size. It would then pay an annual premium.

Leaders need a new way to balance global risks. Here's how.

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 this sense the program would be much 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 would face higher premiums. A country might decide that it still prefers to accumulate a large stock of its own reserves to protect itself. That country could be charged a higher premium, which would serve as a disincentive for 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 dollar amount 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 top up the pool's lines of credit in the event of a global crisis. This would simply institutionalize swap arrangements of the sort that the Federal Reserve and Bank of Japan recently opened up to provide liquidity to other central banks. A key point is that because this insurance pool would be smaller than the collective reserves it's intended to replace, it would not contribute to 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 for international financial regulation. 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 have 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 imbalance problem.

Unless 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 inoculate 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 otherwise finance domestic investment, in low-yield, industrialized-country government bonds. Moreover, large reserve buildups could sow the seeds for the next crisis.

One thing 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 got them into it. Leaders increasingly speak of the importance of coordinated action. Now they need tools, like a global insurance pool, that will help them put that talk into action.

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