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Banks Get Drastic on Plastic

The saga continues in the financial markets as borrowers fall behind on payments, defaults continue to rise, and investors continue to hurt. This situation does not describe the mortgage or automobile fiasco but possibly the next horror story for financial firms – approximately $970 billion worth of outstanding credit card debt.

Traditionally, the credit-card industry has been resilient during economic downturns because of its pricing flexibility. As the economy slows and payments are late, card companies can boost earnings through late fees and higher interest rates. Currently, however, consumers are finding it difficult to repay their debts and defaults are adding up. Now charge-offs which represents the amount which is still owed but the creditor writes off the account balance as a bad debt are increasing at a fast pace and beyond what was expected, the losses are estimated to far surpass what companies were hoping to make with extra card fees and higher interest rates. The net charge-off rate on credit-card defaults might escalate to 10% in 2009; double the average of 5% over the past 10 years reaching $18.6 billion in the first quarter and $96 billion by the end of next year, according to Innovest.

As with the auto industry in Detroit, some of the credit-card industry's current problems have been creeping up over the years. Over the past decade, U.S. households have been loading up on debt, with credit-card balances rising 75% since 1999. Real wages have increased only by approximately 4% during that same time period. The savings rate has similarly declined relative to credit-card balances. Meanwhile, home equity, the biggest source of wealth for most families, has been drained by the mortgage crisis and the rising unemployment rate has exacerbated the problem. These factors will contribute significantly to credit defaults dramatic increase to the highest rate in six years.

Increased use of securitization in the credit-card industry has also fueled some if its growth. Over the past four years, seven of the biggest card issuers packaged more debt into securities, which they sold to investors. This is similar to mortgages as banks bundled groups of so-called credit-card receivables, essentially consumers' outstanding balances, and sell them to investors such as hedge funds and pension funds. Large issuers packaged roughly 70% of their credit-card debt. With credit-card defaults rising and a general "flight to quality" brought on by the subprime mortgage crisis, fewer investors are willing to buy this debt. The securitization market for credit cards was in full operation for the first half of 2008 but is now shut down, making it harder to securitize this category of debt. It was estimated that credit-card issuers will take a $41 billion write down from bad debts in 2008 and $96 billion in 2009. Those losses, in turn, will find their way through the $365 billion market for securities backed by credit-card debt. Banks, now forced to keep more debt on their books, are less willing to lend to anyone who does not have a high credit quality score. The result is a vicious cycle of borrowers being hit with higher interest rates, late fees and curtailed credit lines when funds are needed the most.

Some still believe that the situation is not on the brink of despair. The credit-card industry is being likened to what has happened in the mortgage industry. Some believe that even if credit-card defaults reach a record high of 10% of the approximately $970 billion in revolving debt, a portion of that total will get paid off in full every month, which would result in an aggregate default of less than $100 billion. This number does not compare to the losses that have occurred in the $14 trillion U.S. mortgage market. Moreover, credit card asset-backed securities is not in a lot of investors portfolio or as complex as mortgage asset-backed securities, and they do not have large amounts of credit-default swaps piled on top of them like mortgages. As a result, a total collapse of the credit-card industry would not have the same far-reaching ramifications.

The opposing argument is that even though the credit-card market is just a fraction of the $11.9 trillion mortgage market, the losses from the non-payment can be more painful. This is due to the fact that most credit-card debt is unsecured, meaning consumers would not have to make down-payments or provided collateral when opening an account. When monthly payments are stopped there are no underlying assets for credit-card companies to recoup. In contrast, with mortgages some banks are protected both by down payments and by the ability to recover some of the money by selling the property. In addition to this, the sub-prime threat is also greater with credit-cards as risky borrowers with low credit scores account for roughly 30% of outstanding credit-card debt, compared with 11% of mortgage debt. According to Innovest, more than 45% of Washington Mutual's credit-card portfolio was sub-prime and this could become a problem for JPMorgan Chase, which agreed on September 25 to buy the troubled credit-card business and other assets for $1.9 billion.

Credit-card losses are already having an impact on lenders' balance sheets. Bank of America, the nation's second-largest issuer after JPMorgan, revealed that approximately $3 billion of its $184 billion credit-card portfolio has gone bad, a 50% increase from a year ago. At the same time the bank, which is also dealing with the broader financial tumult, said it would have to cut its dividend by 50% and raise $10 billion in fresh capital. Likewise, American Express (AXP), which provides such credit to the wealthier borrowers, upped its provisions for credit-card losses from $810 million to $1.5 billion in the latest quarter, a sign that even upscale consumers are having trouble. Falling under the weight of consumer debt and defaults, American Express converted itself to a bank holding company, a sign that the once-resilient credit card industry is feeling pressure. It also means they are now allowed access to the $700 billion bailout fund.

To protect consumers, Federal regulators adopted sweeping new rules for the credit card industry that will shield consumers from increases in interest rates on existing account balances among other changes. The rules, which take effect in July 2010, will allow credit card companies to raise interest rates only on new credit cards and future purchases or advances, rather than on current balances. These changes mark the most sweeping clampdown on the credit card industry in decades and are aimed at protecting consumers from arbitrary hikes in interest rates or inadequate time provided to pay the bills.

The credit card business has been a major industry in the US economy and proved in the past that it was able to withstand previous economic storms. However, the current unprecedented financial situation is making this virtually impossible. Previously, lenders competed for years to be the first card to be taken out of the wallet; they are now competing to be the first ones paid back. While the defaults ballooning from the debt is significant, it should not be a major catastrophe as the sub-prime madness but may certainly be a stumbling block on the road to recovery for the US.

Current Happenings in Local and International Markets:

- Central Bank governor says Gov't on right track
- BpTT says no plans for layoff
- PM: Revenue falls by another $3 billion
- World Bank approves US$100 Million for Jamaica's fiscal and debt sustainability
- NCB offers "payment break" to credit card customers
- JMMB planning to close insurance business
- Citigroup Reports $8.3 Billion Loss, Split Into Two Businesses
- Bank of America Posts Quarterly Loss After Bailout
- Mexico Bank May Cut Interest Rate for First Time in Two Years
- Toyota, Honda Widen Production Cuts as Global Outlook Worsens
- PM Gordon Brown Gives $292 Million to Limit Home Repossessions
- European Inflation Slows to Two-Year Low on Energy
- Foreign Direct Investment in China Falls 5.7 Percent

Table 1: Regional Market Performance (as at 15 January 2009)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
TTSE Composite	836.28	-0.53	-1.84	-0.79	-14.80
All Trinidad	1,126.02	-1.93	-3.32	-2.49	-5.87
JSE Index	86,261.97	0.95	7.86	7.62	-19.71
JSE Select	2,014.89	2.52	2.79	1.52	-33.24
All Jamaica	74,762.22	2.05	1.87	1.04	-31.95
BSE Composite	918.17	-0.14	-1.76	-0.18	-10.27

Table 2: International Market Performance (as at 15 January 2009)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
S&P 500	843.74	-7.25	-2.86	-6.59	-38.90
Nasdaq Composite	1,511.84	-6.50	0.23	-4.13	-37.46
Dow Jones Industrial	8,212.49	-6.06	-4.11	-6.43	-34.31
German Dax	4,336.73	-11.13	-6.83	-9.84	-42.68
FTSE 100	4,121.11	-8.53	-3.66	-7.06	-31.61
Nikkei 225	8,023.31	-9.61	-7.40	-8.28	-42.58
Hang Seng	13,242.96	-8.14	-11.99	-7.95	-48.75
DJ Eurostoxx	2,257.67	-10.29	-6.22	-7.91	-45.48