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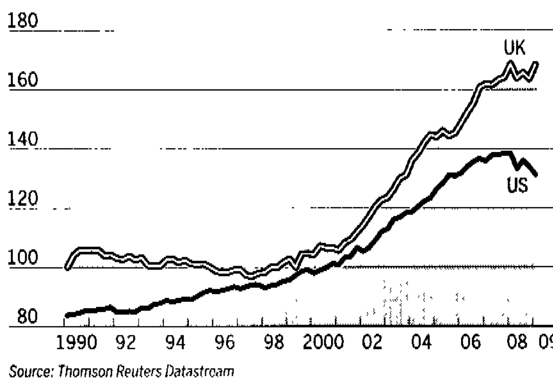
How the cards are cut

Consumer debt As America's banks suffer record defaults on loans, attention is turning to the UK, where households are even more highly geared, write **Patrick Jenkins, Francesco Guerrera** and **Saskia Scholtes**

'The market in general is far too optimistic about the outlook for unsecured consumer debt defaults'

Antonio Horta-Osorio
Chief executive, Abbey



Mick Longfellow is teetering on the edge of financial chaos. A dedicated teacher married to an equally hard-working nurse, living in a modest house in Newcastle in the north-east of England, the pair spent the past decade treating themselves to gadgets, gizmos and home upgrades.

They put in new windows. They bought the biggest television and sound system their living room could accommodate. They changed their cars every year or two. With two children to spoil as well, they were living on credit – lots of it. There were store cards, car loans, personal loans and credit cards.

Now, amid the recession, those lenders want their money back. "The bank just closed down our overdraft. That was the killer blow," says Mr Longfellow. But with the family's debts running to £30,000 ($49,200, €34,600), far more than their annual disposable income, repayment is going to take a very long time.

It is a sad blow for the Longfellows. But multiply one family's debts by the millions of people across the world who are in an even worse state, losing jobs and homes, and the scale of the problem is clear. Estimates from the International Monetary Fund say that of US consumer debt totalling $1,914bn (£1,166bn, €1,346bn), 14 per cent will turn bad. For Europe, it expects 7 per cent of the $2,467bn of consumer debt will be lost, with much of that falling in the UK, the continent's biggest nation of borrowers.

In the US, the carnage is well under way. For nearly two years, banks ranging from giants such as Citigroup to small community lenders have been bleeding as the economic downturn caused "maxed out" consumers to fall behind on their repayments of credit cards, automotive loans, student loans and other once-plentiful forms of credit.

In recent months, what started as a debacle has turned into a nightmare. As unemployment continued to rise and house prices kept falling, the rate of defaults has surpassed historic norms, rendering many of the computer models used by US banks to predict losses useless. In this phase of the crisis, lenders are flying blind.

"We are asking boards of financial institutions to sit down, think about plausible nightmare scenarios and then take measures to deal with them," says Peter Niculescu, a former executive at Fannie Mae, the US mortgage institution, who is now a partner at Capital Market Risk Advisors, a financial consultancy.

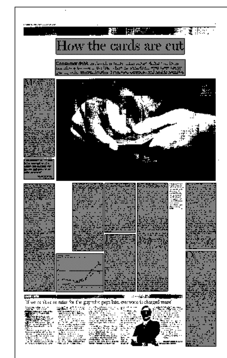
America's story makes a frightening read for banks on the other side of the Atlantic. The question now is what happens next in Europe, particularly in the UK, the continent's biggest consumer lending market, where concrete signs of mass stress have so far been less obvious.

"In the UK, particularly, we haven't seen a lot of discussion about [consumer debt default]," says Nathan Powell, head of financial sector research at RiskMetrics, a credit data group. "There has been a focus on banks' capital, liquidity and their mortgage exposure."

With much of the world in recession, the banking industry has been girding itself for some time against the threat – in recessions banks expect to make losses on loans. But some experts worry whether banks active in Europe, many of which have been rejuvenated by a quick bounce-back in their investment banking operations in the first half of the year, are yet taking sufficient account of the damage that their consumer loan books could yet wreak on profits.

"Proponents of a V-shaped [economic] recovery are underestimating how much rising unemployment and an unstable structure of indebtedness can lengthen and deepen this recession," says Sandy Chen, banks analyst at Panmure Gordon in London.

Historic norms suggest that unsecured consumer loans default at a rate of less than 5 per cent in periods of recession. Although for credit cards the rate is higher, at 7 to 9 per cent, companies charge heftier interest rates to offset the increased risk of default.



But this is no ordinary recession – and no one can agree how bad it is going to get. Some economists argue that the worst may already be over but many believe in a "double-dip" downturn, with another fall-off in demand likely to come later this year. Whether or not that happens, the effects of the first dip are still filtering through to the real world.

Unemployment is still rising – and fast – on both sides of the Atlantic. More than 9 per cent of working-age Americans are now without work, nearly double the year-ago figure, and the UK unemployment tally is at 7.6 per cent. There are widespread expectations that both numbers could soon exceed 10 per cent – and joblessness, unsurprisingly, is the biggest driver of consumer loan default.

The real unknown, however, is to what extent a recession already on a par with the 1930s will be turned into something even worse by record levels of consumer debt. British consumers' leverage – how much they owe as a proportion of income – has been rising fast for a decade and for the past nine months has been running at a record high of more than 170 per cent – far bigger than anywhere else in Europe.

In the US, the percentages have been rising too, and are hovering around the 140 per cent mark. In the last recession, of the early 1990s, UK leverage was barely more than 100 per cent and in the US it was less than 90 per cent. "The severity of this crisis has taken everyone by surprise," says Mr Powell at RiskMetrics. "Delinquencies and charge-offs [the percentage of outstanding loans that is unlikely to be recouped] are deteriorating at a faster rate than anyone expected a year ago."

Industry executives in Europe are beginning to sound like their US counterparts in raising the alarm about spiralling losses on unsecured consumer debt as one of their biggest areas of concern.

"We think the market in general is far too optimistic about the outlook for unsecured consumer debt defaults," says Antonio Horta-Osorio, chief executive of Abbey, the UK business of Spain's Santander. "We have been actively reducing our exposure to consumer lending, so that it is now half the size it was three years ago."

The US experience is showing the way. "It started in subprime mortgages, then it moved to prime mortgages, then to car financing," says Mark Greene, chief executive of Fico, the US credit checking group. "Now it's moving to credit cards."

Over the past 18 months, US banks and card issuers have been coping with the fallout of millions of overleveraged consumers defaulting on an increasing portion of their unsecured debt. Loss rates on credit cards have almost tripled since January 2007 as soaring unemployment, housing woes and the stock market's troubles prompted an ever-increasing number of borrowers to stop paying their balances.

Perhaps more worryingly, the long-held relationship between credit card loss rates and unemployment is breaking down. Credit card loss rates have in the past closely tracked unemployment, topping the jobless rate on just a handful of occasions, and only once by any significant margin. That was in 2005 as a flood of borrowers entered bankruptcy and wrote off their credit card debt before the passage of a law that made it harder to file for bankruptcy.

But in this recession, job redundancies have been compounded by other sources of distress to push credit card losses higher. Losses on US credit cards as measured by Moody's credit card index were at a record of close to 10.8 per cent in June, ahead of the nation's 9.5 per cent unemployment rate.

As the recession has deepened, meanwhile, bankruptcy filings are once more approaching 2005 levels, fuelling the credit card meltdown.

For some banks, losses on credit cards have been severe for months. Credit card loans originated by Washington Mutual, the troubled bank bought by JPMorgan Chase last September, are defaulting at a staggering rate of 24 per cent. Bank of America's June charge-offs were close to 14 per cent and delinquencies – loans that have not been paid – were 1.9 per cent, exceeding the totals for Citigroup, JPMorgan, American Express, Capital One and Discover.

If average charge-off rates reach 18 to 20 per cent, credit card losses for US issuers could exceed $82bn, the Federal Reserve said in May after stress tests on 19 large lenders.

Such losses are proving to be a problem even in cases where the banks thought they had offlaid the risk. Banks such as Citigroup, JPMorgan Chase and Bank of America have had to come to the rescue of the off-balance-sheet vehicles that help them to fund credit card loans, as these vehicles have been weakened by consumer defaults. In Britain, banks argue that they have been more prudent than peers elsewhere, owing to the scare of mass defaults four years ago after the law was changed to make personal bankruptcy via Individual Voluntary Arrangements far easier. That prompted the biggest lenders – Barclays, Lloyds, Royal Bank of Scotland, HBOS (now part of Lloyds) and HSBC – to toughen their criteria for lending: they lent less, and only to people with decent credit records.

But what the banks do not point out is how many of them then let their standards slip at a crucial time. Just ahead of the financial crisis, in 2007, the big five banks (now the big four) started an aggressive expansion of their lending. Barclays is typical – after tempering its consumer lending in 2006, for example, it expanded it from less than £38bn to more than £53bn over the next two years. That kind of expansion at Lloyds and RBS has compounded those groups' balance sheet woes.

When the UK banks start reporting their six-monthly results early next month, they will give some idea of how bad those bad debts are turning out to be. They are already planning for default rates at the top end of historic levels.

One of the best insights into the likely patterns in consumer debt defaults comes from the niche world of credit card securitisations – where the performance data of a second-hand package of a bank's credit card "receivables", or credit repayments, are published monthly.

The so-called Master Trusts of US credit card debt show default rates running at 9 to 18 per cent, up by 50 to 100 per cent over the past year, with most of the rise coming since the start of 2009. With UK trends tending to trail the US by six months, analysts are now watching closely for signs that British securitisations, with default rates running at a relatively stable 7 to 14 per cent, start rising.

The focus on the securitisation data is a stark reminder, too, that it if this highly leveraged recession does lead to record levels of credit defaults, it will not just be the banks that suffer. Analysts estimate that in the UK close to one-third – and in the US about two-thirds – of consumer debt has historically been securitised. If those packages of debt turn bad – or even worse than they had already been reckoned to be – that would hit the investors that are holding them hard.

Some of those investors will be investment banks – compounding the impact of the core lending losses to which their commercial banking rivals (or sister operations) are already exposed.

In other cases, the pain will be even more broadly felt, says Huw van Steenis, analyst at Morgan Stanley. "I think the bigger holders now of securitisations are insurance companies and pension funds." For families such as the Longfellows, with retirement looming in the next decade, that threatens to be the real sting in the tail.

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Credit card debt crisis hangs over Europe

Lenders braced for US-style defaults

7% of $2,467bn debt expected to be lost

By Jane Croft and Megan Murphy in London and Francesco Guerrera in New York

The credit card crisis that has caused billions of dollars in losses among US banks is spreading across the Atlantic, with lenders in the UK and the rest of Europe bracing themselves for a rising wave of defaults among consumers.

The International Monetary Fund estimates that of US consumer debt totalling $1,914bn (€1,346bn), about 14 per cent will turn sour. It expects that 7 per cent of the $2,467bn of consumer debt in Europe will be lost, with much of that falling in the UK, the continent's biggest nation of credit card borrowers.

National Debtline, the UK charity, said that the number of calls it had received from consumers worried about loans, credit cards and mortgage arrears had reached 41,000 in May – double the 20,000 calls it received in May 2008. The number of calls showed no sign of abating, it said.

In the US, credit card defaults have been rising for months as a sharp rise in unemployment and the most severe economic downturn since the Depression have taken their toll on overstretched consumers.

Banks including Citigroup, Bank of America, JPMorgan Chase and Wells Fargo and credit card issuers such as American Express have suffered billions of dollars of losses in their credit card portfolios and have warned of more to come.

The rate of US credit card losses has overtaken the rate of unemployment in recent months – a highly unusual occurrence that makes it more difficult for card issuers to forecast losses.

In the UK, the latest credit card indices from Moody's, the ratings agency, show that annualised charge-off rates have risen from 6.4 per cent of loans in May 2008 to 9.37 per cent in May 2009. In the US, that rate is above 10 per cent.

Analysts expect further defaults as UK unemployment rises and personal insolvencies, which reached 29,774 in the first quarter of the year, continue to increase.

Jonathan Pierce, analyst at Credit Suisse, wrote recently that UK credit card securitisation had suffered "a very sharp rise in arrears to a level well beyond the previous peak seen in 2006".

Barclays, the UK's biggest credit card lender with 11.7m UK customers through Barclaycard, said in May that UK credit card delinquencies had risen in the first quarter, reflecting adverse economic conditions and rising unemployment.

Lloyds Banking Group also said in May it had seen impairments rise in secured and unsecured lending. Lloyds will have to absorb any losses on credit cards itself as the bank has not been able to include credit card loans among the £260bn of toxic assets that it has insured with the UK government.

La crisi del debito delle carte di credito incombe sull'Europa (ca)