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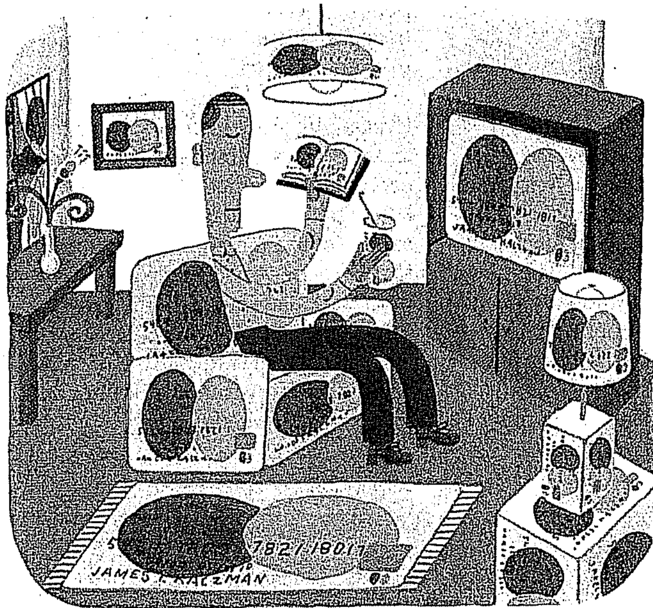
THE SUBPRIME MESS, NOW IN PLASTIC?

If card issuers hike rates and cut credit limits, consumers—and the economy—could take a hit



By Peter Coy

When the housing bust hurt consumer spending this year, plastic came to the rescue. Stung by unwise mortgage lending, banks stepped up credit-card marketing, convinced that plastic was a lower-risk, higher-margin business. Increased card borrowing helped consumer spending rise at a surprisingly fast 2.7% pace in the third quarter.

But this contribution to economic growth may not last. There are early signs that card issuers may need to cut back on their free-lending ways after the holiday shopping season. Delinquency rates on cards have spiked in markets such as Detroit and Las Vegas, where housing prices have fallen the most, according to Equifax and Moody's Economy.com—a warning to card lenders that they aren't insulated from the housing bust. Buyers of card-backed securities—the industry's prime source of capital—are suddenly demanding higher returns. In a possible hint of things to come, Discover Financial Services announced on Dec. 3 a $442 million write-down on its Goldfish credit-card business in Britain.

For now, mailboxes are still stuffed with card offers. Nationally the delinquency rate on credit cards remains low, and banks that issue cards to subprime borrowers were still "going guns blazing" through the third quarter, says Andrew Davidson, vice-president for competitive tracking services at market researcher Synovate, a unit of London-based marketer Aegis.

But things can shift quickly, since card issuers have quite a bit of freedom to raise rates or cut credit limits on existing accounts. On Dec. 4 executives from Discover and Capital One, two of the largest issuers, went before a Senate subcommittee and defended their right to raise rates for a variety of reasons, including a change in economic and financial market conditions—even if the borrowers haven't missed a single payment.

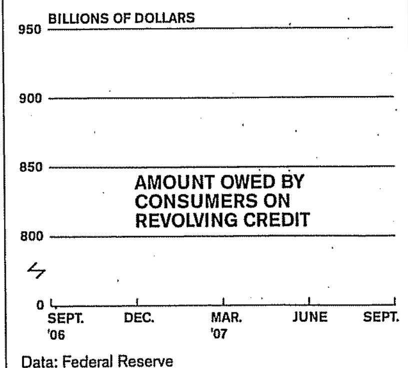
Under pressure from regulators and consumer advocates, major card issuers are moving toward giving customers more notice before a rate change. But realistically the main thing holding issuers back from tightening credit is the fear of losing a customer. If all issuers tighten, that would cease to be an impediment. Dennis Moroney, a senior analyst at TowerGroup, a research firm owned by MasterCard Worldwide, says issuers aren't cracking down during the holiday shopping season but may well do so selectively, mainly in the subprime sector, in January and February.

WORRISOME SIMILARITIES

Market turmoil could make it more expensive and difficult for issuers to fund their operations. So far, credit-card companies have found ready buyers for their securities, which are backed by the flow of payments from cardholders. But investors are demanding higher yields. Until August, yields on three-year, fixed-rate, AAA-rated credit-card securities were a tiny bit below its benchmark, the three-year interest-rate swap rate. But in August they shot up to 0.4 percentage points above the swap rate. After retreating briefly, the spread rose again in late November, to its highest level yet—0.45 percentage points.

These credit-card securities aren't structured like the mortgage-backed securities that blew up recently, but there are enough similarities to be worrisome. Already-skittish investors could require even higher yields if default rates unexpectedly jump. Combine that with issuers' flexibility to quickly change terms and credit could tighten abruptly—especially for the most vulnerable customers. |BW|

TO THE HILT



Data: Federal Reserve

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