Lenders cash in on Americans' passion for spending on credit

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The collection agencies call at least 20 times a day. For a little quiet, Diane McLeod stashes her phone in the dishwasher.

But right up until she hit the wall financially, McLeod was a dream customer for lenders. She juggled not one but two mortgages, both with interest rates that rose over time, and a car loan and high-cost credit card debt. Separated and living with her 20-year-old son, she worked two jobs so she could afford her small, two-bedroom ranch house in suburban Philadelphia, the Kia she drove to work, and the handbags and knickknacks she liked.

New York Times

In 2007, when Diane McLeod earned $48,000, she was charged more than $20,000 in interest on her various loans.

Then last year, back-to-back medical emergencies helped push her over the edge. She could no longer afford either her home payments or her credit card bills. Then she lost her job. Now her home is in foreclosure and her credit profile in ruins.

McLeod, who is 47, readily admits her money problems are largely of her own making. But as surely as it takes two to tango, she had partners in her financial demise. In recent years, those partners, including the financial giants Citigroup, Capital One and GE Capital, were collecting interest payments totaling more than 40 percent of her pretax income and thousands more in fees.

Years of spending more than they earn have left a record number of Americans such as McLeod standing at the financial precipice. They have amassed a mountain of debt that grows ever bigger because of high interest rates and fees.

While the circumstances surrounding these downfalls vary, one element is identical: the lucrative lending practices of America's merchants of debt have led millions of Americans – young and old, native and immigrant, affluent and poor – to the brink.

It is not just individuals but the entire economy that is now suffering. Practices that produced record profits for many banks have shaken the nation's financial system to its foundation. As a growing number of Americans default, banks are recording hundreds of billions of dollars in losses, devastating their shareholders.

To reduce the risk of a domino effect, the Bush administration fashioned an emergency rescue plan last week to shore up Fannie Mae and Freddie Mac, the nation's two largest mortgage finance companies, if necessary.

To be sure, the increased availability of credit has contributed mightily to the American economy and has allowed consumers to make big-ticket purchases such as homes, cars and college educations.

But behind the big increase in consumer debt is a major shift in the way lenders approach their business. In earlier years, actually being repaid by borrowers was crucial to lenders. Now, because so much consumer debt is packaged into securities and sold to investors, repayment of the loans takes on less importance to those lenders than the fees and charges generated when loans are made.

Late fees, 'junk fees'

Lenders have found new ways to squeeze more profit from borrowers. Though prevailing interest rates have fallen to the low single digits in recent years, for example, the rates that credit card issuers routinely charge even borrowers with good credit records have risen, to 19.1 percent last year from 17.7 percent in 2005 – a difference that adds billions of dollars in interest charges annually to credit card bills.

Average late fees rose to $35 in 2007 and fees charged when customers exceed their credit average $26 a month, according to CardWeb, an online publisher of information on payment and credit cards.

Mortgage lenders similarly added or raised fees associated with borrowing to buy a home – such as $75 e-mail charges, $100 document preparation costs and $70 courier fees – bringing the average to $700 a mortgage, according to the Department of Housing and Urban Development. These “junk fees” have risen 50 percent in recent years, said Michael A. Kratzer, president of Feedisclosure.com, a Web site intended to help consumers reduce fees on mortgages.

“Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset,” said Julie L. Williams, chief counsel of the Comptroller of the Currency, in a March 2005 speech.

Lenders have been eager to expand their reach. They have honed sophisticated marketing tactics, gathering personal financial data to tailor their pitches. They have spent hundreds of millions of dollars on advertising campaigns that make debt sound desirable and risk-free. The ads are aimed at people who urgently need loans to pay for health care and other necessities.

Retailers dig in

It is not just financial conglomerates that are profiting on consumer debt loads. Some manufacturers and retailers can generate more income from internal financing arms that lend to their customers than from their primary businesses.

Tallying what the lenders have made off McLeod over the years is revealing. In 2007, when she earned $48,000 before taxes, she was charged more than $20,000 in interest on her various loans.

Her first mortgage, originated by the EquiFirst Corp., charged her $14,136 a year, and her second, held by CitiFinancial, added $4,000. Capital One, a credit card company that charged her 28 percent interest on her balances, billed $1,400 in annual interest. GE Money Bank levied 27 percent on the $1,500 or so that McLeod owed on an account she had with a local jewelry store, adding more than $400.

Olde City Mortgage, the company that arranged one of McLeod's loans, made $6,000 on a single refinancing, and EquiFirst received $890 in a loan origination fee.

Such fees and interest rates are a growing burden on Americans, especially those who rely on credit cards to make ends meet.

And recent changes in the bankruptcy laws, supported by financial services firms, make it all the harder for consumers, especially those with modest incomes, to get out from under their debt by filing for bankruptcy.

But with so many borrowers in trouble, some bankruptcy experts and regulators are beginning to focus on the responsibilities of lenders, such as requiring them to make loans only if they are suitable to the borrowers applying for them.

The Federal Reserve Board, for instance, recently put into effect rules barring a lender from making a loan without regard to the borrower's ability to repay it.

McLeod used debt to keep going until she was fired from her job in March for writing inappropriate e-mail messages. Since then, she has been selling her coveted handbags and other items on eBay to raise money while waiting to be evicted from her home.

“I think a lot of people in this country have a lot more debt than they let the outside world know,” McLeod said. “I worked in retail for five years. And men, women would open up their wallets to pay and the credit cards that were in some of the wallets just amazed me.”

Borrowing to shop

For decades, America's shift from thrift could be summed up in this familiar phrase: When the going gets tough, the tough go shopping. Whether for a car, home, vacation or college degree, the nation's lenders stood ready to assist.

Companies offered first and second mortgages and home equity lines of credit, marketed credit cards for teenagers and helped students to amass upward of $100,000 in debt upon graduation from college.

Every age group up to the elderly was the target of sophisticated ad campaigns and direct mail programs. “Live Richly” was a Citibank message. “Life Takes Visa,” proclaims the nation's largest credit card issuer.

Eliminating negative feelings about indebtedness was the idea behind MasterCard's “Priceless” campaign, the work of McCann-Erickson Worldwide Advertising, which came out in 1997.

“One of the tricks in the credit card business is that people have an inherent guilt with spending,” Jonathan B. Cranin, executive vice president and deputy creative director at the agency, said when the commercials began. “What you want is to have people feel good about their purchases.”

Mortgage lenders took to cold-calling homeowners to persuade them to refinance. Done to reduce borrowers' monthly payments, serial refinancings allowed lenders to charge thousands of dollars in loan processing fees, including appraisals, credit checks, title searches and document preparation fees.

Not surprisingly, such practices generated dazzling profits for the nation's financial companies. And since 2005, when the bankruptcy law was changed, the credit card industry has increased its earnings 25 percent, according to a new study by Michael Simkovic, a former James M. Olin fellow in law and economics at Harvard Law School.

The “2005 bankruptcy reform benefited credit card companies and hurt their customers,” Simkovic noted in his study. He said that even though sponsors of the bankruptcy bill promised that consumers would benefit from lower borrowing costs as delinquent borrowers were held more accountable, the cost of borrowing from credit card companies has actually increased anywhere from 5 percent to 17 percent.

Among the most profitable companies were McLeod's creditors.

Capital One, for example, which charges her 28 percent interest on her credit card, saw net interest income, after provisions for loan losses, rise a compounded 25 percent a year since 2002.

GE Money Bank, which levied a 27 percent rate on Ms. McLeod's debt and is part of the GE Capital Corp., generated profits of $4.3 billion in 2007, more than double the $2.1 billion it earned in 2003.

Because many of these large institutions pool the loans they make and sell them to investors, they are not as vulnerable when the borrowers default. At the end of 2007, for example, one-third of Capital One's $151 billion in managed loans had been sold as securities.

Officials at General Electric declined to comment. Capital One did not return phone calls.

As the profits in this indebtedness grew, financial companies moved aggressively to protect them, spending millions of dollars to lobby against any moves lawmakers might take to rein in questionable lending.

But consumers are voicing anger over lending practices. A recent proposal by the Federal Reserve Board to limit some abusive practices has drawn more than 11,000 letters since May. Most are from irate borrowers.

Rising tide of bills

Just two generations ago, America was a nation of mostly thrifty people living within their means, even setting money aside for unforeseen expenses.

Today, Americans carry $2.56 trillion in consumer debt, up 22 percent since 2000 alone, according to the Federal Reserve Board. The average household's credit card debt is $8,565, up almost 15 percent from 2000.

College debt has more than doubled since 1995. The average student emerges from college carrying $20,000 in educational debt.

Household debt, including mortgages and credit cards, represents 19 percent of household assets, according to the Fed, compared with 13 percent in 1980.

Even as this debt was mounting, incomes stagnated for many Americans. As a result, the percentage of disposable income that consumers must set aside to service their debt – a figure that includes monthly credit card payments, car loans, mortgage interest and principal – has risen to 14.5 percent from 11 percent just 15 years ago.

By contrast, the nation's savings rate, which exceeded 8 percent of disposable income in 1968, stood at 0.4 percent at the end of the first quarter of this year, according to the Bureau of Economic Analysis.

More ominous, as Americans have dug themselves deeper into debt, the value of their assets has started to fall. Mortgage debt stood at $10.5 trillion at the end of last year, more than double the $4.8 trillion just seven years earlier, but home prices that were rising to support increasing levels of debt, such as home equity lines of credit, are now dropping.

The combination of increased debt, falling asset prices and stagnant incomes does not threaten just imprudent borrowers. The entire economy has become vulnerable to the spending slowdown that results when consumers such as McLeod hit the wall.

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