Loan Morass
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pg. 1

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Losses on Credit Cards, Other Consumer Debt Are Climbing Rapidly

Banks and S&Ls Mail Plastic To People Who Spend, Can't Pay and Go Broke

'Too Much of a Good Thing'

By CHARLES F. MCCOY
Staff Reporter of THE WALL STREET JOURNAL

About 18 months ago, Home Federal Savings & Loan Association of San Diego began an ambitious expansion of its credit-card operation to cash in on the fat fees and lucrative rates that that business can bring. "We wanted more of it," says William Mayer, Home Federal's senior vice president for accounting. "We thought it would be a stroll in the park."

The stroll in the park has ended with a mugging. Home Federal mailed offers of pre-approved charge cards with credit lines of as much as $5,000 to people who had no jobs, who were dead or who were just plain deadbeats. Last month, Home Federal decided to abandon the credit-card business by selling it; the S&L said it faces losses of $30 million or more. About half the losses were blamed on people who snapped up Home Federal's easy plastic, ran up huge bills and headed straight for bankruptcy court.

"We managed to find an unbelievable number of consumers who wound up broke," Mr. Mayer says. "We got blindsided."

Wide-Ranging Effects

A lot of other financial institutions face similar trouble. After three years of wild growth, consumer debt is fast becoming another sinkhole in lenders' credit swamp. Beyond the jolt that threatens for an already-shaky banking industry, a growing number of economists cite such evidence as October's record monthly drop in retail sales as signals that a deterioration in consumer debt has spilled over into the general economy, menacing the recovery and possibly presaging another recession.

"The consumer has been the guts of this economic expansion," says Edward Yardeni, the chief economist at Prudential-Bache Securities Inc. "If he is so soaked with debt that spending slows, that's it—the expansion is finished. Consumer debt is a problem for a lot more than bankers."

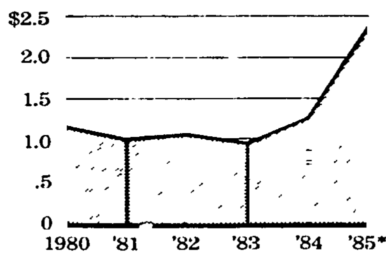
Over the past three years, lenders chasing rich returns and consumers chasing the good life have pumped up consumer installment debt to a record $524.3 billion, a 57% surge from $335 billion at the end of 1982, according to the Federal Reserve Board. In September alone, consumer debt jumped $10.6 billion, another record, partly because of a surge in auto sales.

Many Disasters

But often credit has been given where credit isn't due. Bankers have climbed further and further down the economic ladder in the frenzied search for new customers. Prisoners, unemployed teen-agers, even a few household pets have received credit cards.

Mary Ceballos, a San Diego secretary whose salary is $16,100 a year, says she

Consumer Loan Losses



Note: For banks with at least $300 million in assets
*Estimate
Source: Based on FDIC data

was "mildly surprised" when Home Federal sent her a MasterCard with a $5,000 line of credit earlier this year. She was more surprised when, within a matter of weeks, Home Federal sent her two more. Mrs. Ceballos says she owed the thrift more than $9,000 when she recently filed for personal bankruptcy.

Such episodes are becoming more and more common. In the first half of 1985, consumer loan losses just at banks with more than $300 million of assets surged to almost $1 billion, nearly double the year-earlier level. Losses at smaller banks were up by one-third to $214 million.

Delinquencies High

Much heavier losses loom. Almost all types of consumer debt are going bad at near-record rates. About $2 billion of debt run up on bank-issued credit cards such as Visa and MasterCard is delinquent, based on data compiled by the American Bankers Association. Some 3.5% of all personal loans—loans on cars, second mortgages and the like—are past due, more than at almost any other time in the past five years. Mortgage-loan delinquencies are still hovering close to the all-time peak hit earlier this year. All told, roughly $48 billion of the $2.6 trillion of consumer and mortgage debt is past due.

"A lot of those loans might as well have been made to Poland," laments Gary Burton, the vice president of credit-card operations at Liberty National Bank & Trust Co., a big card issuer based in Oklahoma City. "Our industry has flat overdone it."

However, losses on consumer debt are

Please Turn to Page 26, Column 3

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Loan Morass: Losses Are Soaring On Credit Cards and Other Debt

Continued From First Page

widely dispersed throughout the banking system. That suggests that they aren't concentrated enough to cripple scores of institutions, as farm and energy loans have done. Credit cards' steep fees and rates have kept that business profitable for most banks, in spite of surging charge-offs. And many big institutions are willing to absorb charge-card losses because the cards are seen as a way to build a nationwide customer base in anticipation of interstate banking a few years hence.

Nonetheless, bad consumer debt is gnawing at some of banking's biggest names. Citicorp, the largest bank-card issuer with some 11 million charge-card accounts, wrote off $492 million of consumer debt this year through Sept. 30, more than double the year-earlier amount. John Reed, the chairman and chief executive, concedes that consumer losses have grown faster than the bank anticipated, and he predicts higher charge-offs next year.

First Chicago Corp., which has expanded its credit-card business 30% to three million cards outstanding in the past two years, has seen its consumer losses in the nine months climb to $64.8 million from $25 million. George Salem, banking-securities analyst at Donaldson, Lufkin & Jenrette, says First Chicago's credit-card losses are running about twice the normal percentage level.

Keefe, Bruyette & Woods Inc., a bank-securities firm, recently cut its 1985 earnings projection for First Atlanta Corp. to $2.25 a share from $2.40; it cited "unexpectedly high continuing" losses in the bank's $930 million credit-card portfolio. And beleaguered BankAmerica Corp., whose nine-month consumer-loan losses surged 64% to $189 million, concedes that losses on its more than five million credit-card accounts are running 10% higher than expected.

Ironically, bankers have stampeded into consumer lending partly in search of a profitable refuge from the loan disasters in commercial-banking mainstays such as the steel, shipping and energy industries. But, "we all charged at the consumer at once," says Allen Sanborn, executive vice president at BankAmerica. "When you push a market that hard, there has to be some deterioration." Indeed, the ratio of losses on consumer loans to losses on commercial loans, 1 to 5 last year, has narrowed to 1 to 2. "There's certainly some danger in this that not everyone saw several years ago," Mr. Sanborn adds.

Both the perils and the allure of consumer debt show up most in banks' credit-card operations. They have been the arena of some of the most explosive growth: Banks and thrifts had about $68.1 billion in credit-card debt outstanding as of July 31, up 86% since 1982.

The primary attractions for bankers are interest rates that are averaging about 19.4%—10 percentage points above the prime, the basic lending rate to businesses—and annual fees that can range as high as $25 a card. But cards also appeal to the new breed of banking technocrat. By using elaborate statistical models and computer runs, some bankers contend that they can weed out bad credit risks, limit defaults and predict losses accurately.

"It's a business where you can really limit surprises," Ira Rimmerman, the head of Citicorp's international consumer operations, said in an interview earlier this year. "It is almost actuarial in nature."

Changes Ignored

That clearly hasn't proved true, and some bankers now suggest that credit-card operators have abstracted themselves into a morass. "These people with their models are very sharp, but they can lose sight of one thing: At some point, the condition of consumers changes, and the models become so removed from reality that they're meaningless," says John Rau, the president of Exchange National Bank in Chicago.

Credit-card underwriting often does seem something short of scientific. Institutions usually find credit-card customers by simply mailing out thousands of applications or offers of pre-approved cards. They often cull prospects from subscription lists of upscale magazines; Home Federal, for example, targeted Forbes subscribers during much of its ill-fated credit-card expansion. Generally, credit bureaus are hired to trace each prospect's credit history.

But such mail-order credit reviews frequently don't turn up elemental information. A former credit officer at Bank of New Orleans recalls sending credit cards to a batch of consumers who the bank's computers showed had steady jobs and noteworthy records. True enough: They were inmates at Angola State Prison, 125 miles northwest of New Orleans.

Other Strange Cases

Other practices seem equally dubious. Early this year, Citicorp sent a $1,500 credit card to an 18-year-old girl just graduated from high school. She had no job and no savings account, but she soon had a car—leased on her Citicorp card. In another case, Kathy Buckner, a 22-year-old Houston computer technician, received a Diner's Club credit card from Citicorp and a MasterCard from First City Bancorp. in Houston about two years ago. Her take-home pay at the time: $12,000. She now owes about $11,000, some $5,000 on credit cards. "It'll take me years to get debt-free," Miss Buckner says.

So many institutions have been shoving plastic at consumers these days that it has become almost impossible for lenders to gauge how many cards their prospects have.

"Your credit review may show that on such-and-such date, this person had one credit card and a good record, so you send him a card," Home Federal's Mr. Mayer says. "What you don't know is that at the same time you were sending him a card, so were Bank of America, Citicorp, Security Pacific. Pretty soon, that person who looked like a good credit risk has enormous potential for getting in trouble."

Richard Adolphson's case seems a classic. A 59-year-old security guard at an ammunition plant in Burlington, Iowa, he earns about $22,000 a year and had always paid his few debts promptly. When banks all over the country began stuffing his mailbox with offers of pre-approved plastic, he happily signed on.

But when he filed for bankruptcy last year, he owed $35,250.81, mostly on his 31 credit cards, and his interest costs alone were running nearly $6,000 a year. He had at least six cards from First National Bank of Omaha, Neb., one of the biggest credit-card issuers in the Midwest. First Chicago, Chemical Bank, Michigan National Bank and half a dozen others also gave him cards, all in a matter of months. "They kept sending me cards, so I figured I must have been OK," he says. "Either that or they were awfully lax."

Now, a few banks, getting nervous, have begun to curtail credit-card promotions. Some bankers also worry that Congress, pressured by consumer groups, may move to limit the rates that banks can charge on credit cards—cutting into profits.

Mostly, though, lenders continue to shovel credit out to consumers. Sears, Roebuck & Co. is hawking its new Discover credit card; it hopes ultimately to issue some 10 million. RepublicBank Corp., the biggest bank in Texas, has just launched a major credit-card push after long shying away from expanding the business. Thrifts, which did little consumer lending before 1981 but now hold some $40 billion in consumer debt, are barreling into credit cards; First Federal Savings & Loan Association in Detroit, for example, began issuing cards last summer. Great Western Savings in Beverly Hills, Calif., ballooned its credit-card loans to $222.6 million at Sept. 30 from $65 million at the end of 1983.

All that activity is viewed with bemusement by Home Federal's Mr. Mayer. "We found out that credit cards are like everything else in banking," he says. "It starts out a good thing, but pretty soon everybody's diving into it. And then, it's too much of a good thing."

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