

# Charge-offs Expected to March Upward

Home pricing, mortgage interest rate resets and bankruptcy filings will be the key influences this year on credit card delinquencies and charge-offs. By Corinna C. Petry

**A**FTER FINANCIALLY troubled Americans, their lawyers and the courts worked through limitations of the revised U.S. bankruptcy code, which became effective in October 2005, consumer bankruptcy filings rebounded – but not to previous levels. Not yet, at least.

Consumers and businesses filed 623,399 bankruptcy petitions during the first nine months of 2007, a 40% increase over the 444,789 cases filed during the same period in 2006.

Market observers say the rebound in bankruptcies was the biggest factor in last year's significant increase

in credit card charge-offs. But there is still far to go before reaching the peak years of 2000 to 2004, when annual filings averaged 1.4 million to 1.5 million.

Other factors include Americans' total debt burden, the housing market, unemployment rates and consumer prices – especially fuel. Bankers and analysts are still trying to judge how badly the subprime mortgage crisis might bleed into the credit card market.

Net charge-offs of credit card loans at all FDIC-insured institutions through the first nine months of 2007 totaled roughly \$11.5 billion, up \$1.54 billion or

## credit card outlook

15.5% from approximately \$9.95 billion during the first nine months of 2006 (see Table 1, right).

The recovery rate on charged-off card loans fell to 16.4% year to date in 2007, compared with 19.4% in the same period of 2006.

Among 15 card issuers studied by *Collections & Credit Risk* – including leaders such as Bank of America, JPMorgan Chase, Citigroup and American Express – only Discover Financial Services reported a slight (1.2%) decline in charge-offs through the first nine months of 2007, compared with the year before. The group's combined charge-offs increased 22.1% year over year.

Based on CCR's research – aided by ratings services, industry consultants and debt buyers – credit card delinquencies and charge-offs are projected to rise again in 2008. Eventually that should lead to more business for asset liquidators and collection firms.

Moody's Investors Service forecasts U.S. credit card charge-off rates will increase throughout 2008 "due mainly to an expectation that bankruptcy filings will continue to rise to a level at or near levels achieved prior to the October 2005 change in bankruptcy law," according to a November research report.

Moody's noted that the delinquency rate for card payments had risen each quarter since the fourth quarter of 2006 and reached 3.89% in the third quarter of 2007. The 4.59% card loan charge-off rate seen in the third quarter of 2007 marked the third consecutive quarterly year-over-year increase after 12 straight quarters of improvement beginning in the first quarter of 2004.

### Housing Market Ripples

Goldman Sachs analysts downgraded Discover – the only one of 15 issuers CCR traced that reduced its charge-offs – to "sell" on Nov. 19, citing the effects of falling real estate values.

"House prices have much further to fall," Goldman Sachs said. "We esti-

### Credit Card Charge-offs Nationwide All FDIC-insured institutions

(\$ in thousands)	YTD 9/30/07 8,650 institutions reporting	YTD 9/30/06 8,743 institutions reporting	% change
<b>Credit card charge-offs</b>	\$13,742,939	\$12,350,609	11.3%
<b>Credit card recoveries</b>	2,250,872	2,399,385	-6.2%
<b>Net credit card charge-offs</b>	11,492,067	9,951,224	15.5%

Source: Federal Deposit Insurance Corporation and Collections & Credit Risk

mate the U.S. median house price to be 13% to 14% above levels implied by current and forecast economic conditions. Such a fall should impact consumer spending as well as consumer credit trends."

The analysts felt that Discover was underestimating its projected 2008 charge-off rate by as much as 75 basis points: "We forecast charge-off rates of 5.0% and 5.6% in 2008 and 2009, respectively."

Total consumer credit outstanding in the third quarter of 2007, at \$2.48 trillion, increased nearly 5.1% from \$2.36 trillion in the same three months of 2006. Revolving credit – primarily credit card borrowing – totaled \$920.1 billion, for a seasonally adjusted growth rate of 7.6% year over year.

"When the economy is sucking wind, and you have regulatory issues and the collapse of the subprime mortgage market, it makes it more difficult to get people to pay what they owe. We see that happening," says Gary Wood, president of debt buyer Collins Financial Services, based in Austin, Texas.

In the recent past, mortgage refinancing was a major source of consumer debt payments, Wood says. "That has pretty much dried up. The principal source of wealth is the money in their home. If it's no longer available, their ability to tap into non-income funds is greatly reduced," he says.

As adjustable rate mortgages move to higher interest rates, "it puts an additional squeeze on people," says Wood. "The decision they have to make is: Which bills do I pay this

month? A lot will choose to pay their mortgage to hang on to the house. So other debts – credit cards, auto loans – will suffer. The result is we're likely to see an increasing supply of charge-offs. In the first three quarters of 2008, there will be an increase in credit card, auto deficiencies and consumer loan paper," he predicts.

According to Lou DiPalma, managing partner of Garnet Capital Advisors LLC, based in Harrison, N.Y., "You have to put the subprime mortgage crisis at the top of the list" of factors that will continue to affect card payments, delinquencies and charge-offs.

"Clearly there is a slice of America that was getting credit that was underpriced," DiPalma says. "A lot of the run-up in prices for charged-off credit cards was because borrowers paid with mortgage refinancing. More people owned homes [but] that 3% or 5% increase in homeownership [over the past few years] was all subprime," he says.

"It will affect recoveries, and have a domino effect on prices and issuers' willingness to sell," says DiPalma. "Banks have taken huge write-downs and will have continual losses – maybe recovering in 2009 and 2010."

A growing amount of defaulted card accounts, not to mention troubles within other loan categories, was expected to compel card issuers to sell a great deal of charged-off paper during the fourth quarter of 2007.

"It's an open secret that credit issuers are ready to sell. Write-offs have

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been painful," says Mark Russell, a director at Kaulkin Ginsberg, Rockville, Md.-based consultants to the accounts receivable management industry.

Market observers who spoke with CCR hesitated to make solid predictions about portfolio supply in the new year, saying what happened in the fourth quarter will have a direct bearing on what issuers do in 2008.

"Prime issuers with performing portfolios will sell them for a couple different reasons," says Tim Kolk, managing partner at card industry consultants Brookwood Capital, based in Petersborough, N.H. "Some sell a portion of a portfolio. They'll find accounts that are not strategic to them. The pricing out there is really pretty attractive [for performing debt]. Here are premiums as good as we've ever seen, as long as the credit quality is average or better than average."

Other creditors will decide they no longer want to be issuers because of what it takes to compete in that space and because the risk is too great, Kolk says. They will sell off their entire portfolio. "The market for those is incredibly strong [and] there are spectacular premiums on that kind of product," he says.

The warnings on risk have been occurring in different parts of a bank's assets, he continues. "If mortgages get worse, it can't bode well for card portfolios, but issuers are making attractive returns and profits on cards."

There is pressure on card managers to keep risk low in spite of the moribund economy, but continue to do more card lending, says Kolk. "I don't know how that tension will resolve itself."

Dave Ludwig, president of National Loan Exchange Inc., a Carlsbad, Calif.-based debt broker, says card issuers predict a 15% to 20% increase in charge-off rates through the second quarter, compared with the first half of 2007. "We are

anticipating a 30% increase in sales volume from issuers as compared to the first six months of 2007," he says.

## Portfolio Pricing Predictions

Kolk believes it is a seller's market for performing portfolios and issuers have not yet brought down their asking prices.

"There is so much concern about the overall economy, and the bleeding of the housing credit crisis into what have traditionally been even riskier loans - credit cards - that buyers of card debt are paying a real premium for proven low-loss portfolios. Buying proven assets may be expensive, but the outcome is more predictable."

Wood at Collins Financial notes that banks "have taken a pounding on their losses in the subprime market,"

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TIM KOLK, BROOKWOOD CAPITAL

and the revenue they could generate by selling debt could help stem the flow.

On nonperforming card paper, "prices have not come down that much," Wood says. "They have softened some, but they still reflect more of a herd mentality than a careful analysis of what you're buying."

Ludwig predicts demand will continue to chase supply for the near future, but at lower prices. Pricing for primary issued credit cards with good supporting documentation has already fallen 10% to 15% since the fourth quarter 2006, he says.

DiPalma at Garnet Capital agrees card portfolio prices have dropped 11% or 12% in the past year and will continue to slide. "The supply-demand balance is becoming more normalized. It had been a market of more buyers than sellers. I think we will have a more balanced market, which means prices

will come down," but not substantially.

Kaulkin Ginsberg's Russell believes prices will remain stable at the fresh charge-off level, which will keep some buyers sidelined and push still others aside. "The number of buyers in the pool that will be able to compete for fresh paper will go down slightly," he says.

Going into 2008, the market is harder to gauge "because we have to see the results of the fourth-quarter sell-off," says Russell. "If things happen the way they're expected to, selling activity could increase from 2007. This fits with the expected increase in delinquencies and charge-offs and agency placements.

"If issuers get concerned that the credit crunch and subprime fallout will hurt internal collection efforts, they may end up selling more," he says.

Aktiv Kapital, an Oslo, Norway-based debt buyer and collector, recently told investors that while developments in the subprime lending sector have reduced available funds for financial services as a whole, this "may result in more conservative prices for non-performing consumer loans."

Aktiv's board of directors issued a statement saying the subprime debacle and other trends create a window of opportunity.

"The pipeline for future purchases is significant and we continue to see a positive trend among financial institutions to either outsource or divest the collection of non-performing loans. New and existing vendors are bringing material portfolios up for sale."

If the supply of card paper does increase enough, and prices fall, buyers that are securely backed by their own lines of credit will seize the day. **CCR**