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Another Day Older and Deeper in Debt

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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, Ms. 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.

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.

Ms. 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 like Ms. 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. More and more, Americans can identify with late 19th and early 20th century miners in debt to the company store, with little chance of paying up.

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 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 like 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.

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 from less than $13 in 1994, and fees charged when customers exceed their credit limits more than doubled to $26 a month from $11, 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 — like $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 that received little notice at the time.

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.

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 Ms. 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 Corporation, 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 Ms. 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 Ms. 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, like 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.

Henry E. Hildebrand III, a Bankruptcy Court trustee in Nashville since 1982 and one of the nation's busiest, has seen at first hand what happens when lenders do not take some responsibility for loans that go bad.

"I look across the table at people who are right out of school and have more debt than they can handle, and they are starting out life in a bankruptcy," he said.

Ms. 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," Ms. 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, 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.” Mr. 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 Ms. 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 Corporation, 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.

A 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, like 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 like Ms. McLeod hit the wall.

That First Credit Card

Growing up in Philadelphia, Diane McLeod never knew financial hardship, she said. Her father owned six pizza shops and her mother was a homemaker.

“There was always money for everything, whether it was bills or food shopping or a spur-of-the-moment vacation,” Ms. McLeod recalled. “If they worried about money, they never let us know.”

Hers was a pay-as-you-go family, she said. Although money was not discussed much around the dinner table, credit card debt was not a part of her parents’ financial plan, and sometimes personal purchases were put off.

When Ms. McLeod married at 18, she and her husband carried no credit cards. She stayed at home after her son was born, but when she was 27 her husband died.

She remarried a few years later and continued as a homemaker until her son turned 13. Between her husband’s job laying carpets and her own, money was not exactly tight.

In the mid-’90s, Ms. McLeod got several credit cards. When the marriage began to founder, she said, she shopped to make herself feel better.

Earning a livable wage at Verizon Yellow Pages, Ms. McLeod finally decided to leave her marriage and buy a home of her own in February 2003. The cost was $135,000, and her mortgage required no down payment because her credit history was good.

“I was very proud of myself when I bought the house,” Ms. McLeod explained. “I thought I would live here till I died.” Adding to her burden, however, was about $25,000 in credit card debt she had brought from her marriage. Because her husband did not have a regular salary, all the cards were in her name.

After she had been in the house for a year, a friend who was a mortgage broker suggested she consolidate her debts into a new home loan. The property had appreciated by about $30,000, and once again she put no money down for the loan. “It was amazing how easy it was,” she recalled. “But that’s a trap, and I didn’t know it then.”

Naturally, the refinance had costs. There was an $8,000 penalty to pay off the previous mortgage early as well as roughly $1,500 in closing costs on the new loan.

To cover these fees, Ms. McLeod dipped into her retirement account. Only later did she realize that she had to pay an early-withdrawal penalty of $3,000 to the Internal Revenue Service. Short on cash, she put it on a credit card.

Soon she had racked up another $19,000 in credit card debt. But because her home had appreciated, she once again refinanced her mortgage. Although she was making $50,000 a year working two jobs, her income was not enough to support the new $165,000 loan. She asked her son to join her on the loan application; with his income, the numbers worked.

“Boy, would I regret that,” she said. The decision would drive a wedge between mother and son and damage his credit profile as well.

Almost immediately after she refinanced, in late 2005, the department store where she worked her second job, as a jewelry salesperson at night and on weekends, cut back her hours. She quit altogether, and her son moved out of the house, where he had been helping with the rent, to live with a girlfriend. Ms. McLeod was on her own and paying $1,500 a month on her mortgage.

Because the house had been recently appraised at $228,000, she said, she felt sure she could refinance again if she needed to pay off her credit card. “You felt like you had a way out,” she said.

But as happens with many debt-laden Americans, an unexpected illness helped push Ms. McLeod over the edge. In January 2006, her doctor told her she needed a hysterectomy. She had health care coverage, but she could no longer work at a second job.

She made matters worse during her recovery, while watching home shopping channels. “Eight weeks in bed by yourself is very dangerous when you have a TV and credit card,” Ms. McLeod said. “QVC was my friend.”

Later that year, Ms. McLeod realized she was in trouble, squeezed by her mortgage and credit card payments, her $350 monthly car bill, rising energy prices and a stagnant salary. She started to sell knickknacks, handbags, clothing and other items on eBay to help cover her heating and food bills. She stopped paying her credit cards so that she could afford her mortgage.

A year ago she was back in the hospital, this time with a burst appendix. Her condition worsened, and she lost the use of one kidney. She spent 19 days in the hospital and six weeks recuperating. Her prescription-drug costs added to her expenses, and by September she could no longer pay her mortgage.

When her father died in early January, she was devastated. About a month later, on Feb. 14, Ms. McLeod was suspended and soon afterward fired from Verizon.

Toting up her financial obligations, Ms. McLeod said she owed $237,000 on her home mortgage. Of that, sheriff’s costs are $4,350, and “other” fees related to the foreclosure come to $3,000. A house of similar size down the street from Ms. McLeod sold for $153,000 in January.

Her credit card debt totals around $34,000, she said. Each month the late fees and over-limit penalties add to her debt. Ms. McLeod said she will probably file for bankruptcy.

Patricia A. Hasson, president of the Credit Counseling Service of Delaware Valley, said Ms. McLeod would probably wind up having to repay 40 percent to 60 percent of her credit card debt. The owner of her mortgages could come after her for the difference between what she owes on her loan and what her house ultimately sells for. The first mortgage was sold to investors; Citigroup declined to say whether it held onto the second mortgage or sold it to investors.

A sheriff's auction of her home on June 12 received no bidders, Ms. McLeod said. The bank will soon evict her.

"Oh, I definitely have regrets," Ms. McLeod said. "I regret not dealing with my emotions instead of just shopping. And I regret involving my son in all this because that has affected him and his finances and his self-esteem."

Ms. McLeod says she hopes to be living in an apartment she can afford soon and to get back to paying her bills on time.

She does not want another credit card, she said. But even though her credit profile is ruined, she still receives come-ons.

Recently an envelope arrived offering a "pre-qualified" Salute Visa Gold card issued by Urban Bank Trust. "We think you deserve more credit!" it said in bold type.

A spokeswoman at Urban Bank said the Salute Visa is part of a program "designed to provide access to credit for folks who would not otherwise qualify for credit."

The Salute Visa offered Ms. McLeod a $300 credit line. But a closer look at the fine print showed that $150 of that would go, as annual fees, to Urban Bank.