Why America's Really in Debt

The Motley Fool

By Dayana Yochim

Forget everything you thought you knew about America's debt problems. It's not reckless spenders racking up a record $800 billion in balances on credit cards that's the problem. The problem is with average Americans just trying to make ends meet, according to a new study.

In the past six years, credit card debt has nearly tripled. And last year, 1.8 million people declared bankruptcy, up from 616,000 in 1989. What are those who owe putting on plastic? It's not designer duds and criminally priced movie theater popcorn. It's basic living expenses.

More than 1,000 households were surveyed. (To participate, they had to have credit card debt for three months or longer and household income between 50% and 120% of the local median income, establishing them as low- and middle-income households.) Their answers provide context for the growing void between the haves and have-nots and reveal the fallout from more than a decade of irresponsible lending practices, increasingly predatory fees, and growing economic instability.

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Seven out of 10 low- and middle-income households surveyed reported using credit as a survival safety net. One household out of three said it was forced to put these charges on a card for four out of the past 12 months because the household didn't have the cash available to cover the bills.

The average amount of debt carried by survey respondents was $8,650; 29% were strapped with more than 10 grand on credit cards, while 24% carried between $2,500 and $5,000, and 31% owed less than $2,500.

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Unfortunately, debt tends to linger. The average amount of time of debt was about three and a half years, according to the survey. Lenders certainly aren't rushing consumers to pay down their balances, despite the recent increase in minimum payment requirements. Last year, banks made $80 billion in interest charges, and the industry raked in an all-time high of $31 billion in fee income, which includes annual fees, cash-advance fees, balance transfer fees, and merchant fees.

Why can't you pay it off?
Layoffs, major medical expenses, education costs, and bad transmissions are evidently the things that separate the economically vulnerable from the fiscally stalwart. When asked to cite what contributed to their current level of debt, respondents cited the following:

Misinformation about establishing credit was also cited. Thirteen percent of consumers said they were carrying debt to improve their credit score. But it's not how much debt you carry that boosts your score, nor is it that you keep a balance on your credit card. It's how you handle the credit extended to you. Time (the longer the better) and the responsible use of credit (paying your bills on time and keeping your debt-to-available-credit ratio well below 25%) are the best ways to build a solid credit history.

What are we doing to pay it off?
Despite stereotypes of deadbeat debtors, just 11% of survey respondents said they would continue to use their credit cards as they had in the past. Nearly half said they had immediate plans to keep their cards in their wallets so they could pay off the debt, and 33% said they would like to do the same but that they would have to use credit as needed.

In fact, nine out of 10 customers try to pay more than the minimum required payment each month (the average amount paid among all respondents was $700) — and 41% of those paying more said they planned to pay two to three times what lenders required to get rid of their balances quicker.

Slackers, these customers aren't: Two-thirds of households said they were budgeting to control expenses. More than half had cut back discretionary spending in the past six months.

But good intentions aren't enough, particularly when lenders are watching every move their customers make. Increasing penalty rates — and the growing reasons for instituting them — are certainly keeping debt-strapped households in the cycle.

This year, credit card companies will rake in $16 billion in penalty fees — what Mark Peace, the president of the Center for Responsible Lending, calls the penalty-pricing trap. Not only are late fees at an all-time high (less than half of consumers said they had missed or were late with a payment in the past year), but lenders also now hike interest rates after a single late payment — even if it's a bill from another lending institution altogether.

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More than 40% of lenders now use the universal default clause. Via routine credit report checks, they see whether you have been behind in any of your bills, thus marking you as a higher credit risk. Lenient lender-consumer card agreements stipulate that they can increase a customer's interest rate two- or three-fold if they want. (The average default rate is 25%. Companies cited as "steep chargers" include **Providian** (NYSE: PVN), **Bank of America** (NYSE: BAC), and **MBNA** (NYSE: KRB).

A 25% penalty rate translates into more than $1,100 in additional interest costs each year for a household with the average debt load of $8,650 originally at 12% interest. "Dear valued customer, thanks for the $16 billion bonus!"

The ultimate bottom line

Covering their assets is certainly within lenders' rights. But responsible lending practices seem to have taken a back seat to bottom-line results.

Credit card companies aren't just encouraging card-shuffling — hopping from one lender to another — when they send out 5 billion solicitations annually. They're cheering on consumers to take on more credit than they can handle. "Treat yourself right this month," they tell us with "convenience checks" loaded with fees. "Oh, and if you slip up and we find out about it — and trust, us, we're looking — forget that sweet low-rate deal we just mentioned. Everything you've charged up to now and from here on out will be subject to a meaty interest rate."

When the bankruptcy bill goes into effect on Oct. 17, lenders get yet another hand to play in their favor. The Plastic Safety Net study shows that even the best-intentioned debt-strapped households — and most of them are diligent about their finances — are living in a house of cards.