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CONSUMER DEBT: ARE CREDIT CARDS BANKRUPTING AMERICANS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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CONTENTS

APRIL 2, 2009

Page

OPENING STATEMENTS

The Honorable Steve Cohen, a Representative in Congress from the State of Tennessee, and Chairman, Subcommittee on Commercial and Administrative Law 1
The Honorable John Conyers, Jr., a Representative in Congress from the State of Michigan, Chairman, Committee on the Judiciary, and Member, Subcommittee on Commercial and Administrative Law 2
The Honorable William D. Delahunt, a Representative in Congress from the State of Massachusetts, and Member, Subcommittee on Commercial and Administrative Law 3
The Honorable Trent Franks, a Representative in Congress from the State of Arizona, and Ranking Member, Subcommittee on Commercial and Administrative Law 4

WITNESSES

Mr. Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center
Oral Testimony 8
Prepared Statement 11
Mr. David C. John, Senior Research Fellow, Thomas A. Roe Institute for Economic Policy Studies, The Heritage Foundation
Oral Testimony 23
Prepared Statement 25
Mr. Brett Weiss, Attorney, Greenbelt, MD, on behalf of the National Association of Consumer Bankruptcy Attorneys
Oral Testimony 32
Prepared Statement 34
Mr. Edmund Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group
Oral Testimony 41
Prepared Statement 43

LETTERS, STATEMENTS, ETC., SUBMITTED FOR THE HEARING

Material Submitted for the Hearing by the Honorable Trent Franks, a Representative in Congress from the State of Arizona, and Ranking Member, Subcommittee on Commercial and Administrative Law 5

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

Response to Post-Hearing Questions from Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center 88
Response to Post-Hearing Questions from Brett Weiss, Attorney, Greenbelt, MD 90
Response to Post-Hearing Questions from Edmund Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group 91

CONSUMER DEBT: ARE CREDIT CARDS BANKRUPTING AMERICANS?

THURSDAY, APRIL 2, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3 p.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Conyers, Delahunt, Maffei, Franks, Coble, and Forbes.

Staff Present: James Park, Majority Counsel; Michone Johnson, Majority Chief Counsel; and Daniel Flores, Minority Counsel.

Mr. COHEN. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, no longer known as CAL for that reminds me of Calipari, amongst other things, will now come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing if necessary. I will recognize myself for a short statement.

Today's hearing on credit card practices and bankruptcy is the first in a series of hearings that the subcommittee plans to hold on how America has reached the present economic crisis that we are in today and whether our Nation's bankruptcy system is prepared to help us weather this crisis, and whether it contributed to the crisis as well.

Americans' credit card debt has grown exponentially over the past two decades. In 1990 the average American household's credit card was $2,966, approximately $3,000. By 2007 that number has jumped to $9,840, almost $10,000. That is 3,000 to 10,000, and that is 33 percent.

Moreover, Americans are finding it harder to pay down their credit card debt. Charge-off rates, the amount of debt determined uncollectible by the original creditor, divided by the average outstanding credit card balances owed to the issuer were 40 percent higher in January 2009 than they were in the year before. And credit card debt that was at least 30 days late totaled 17.6 in October, 2007. That was up 26 percent from the previous year. And of course as unemployment goes up and the economy gets worse, these rates will get worse, too.

There are many reasons why people accumulate credit card debt. Many attribute personal debt to overspending or living beyond one's means. However, credit card debt often results because of household bills that accumulate due to a loss of job or colossal medical bills. Increasingly, predatory lending tactics and irresponsible lending is a large contributor to climbing credit card debt we have in this country.

This hearing of the subcommittee will examine some of the more abusive credit card lending practices that may exacerbate the burden borne by credit card debtors. Such practices include excessive penalty fees and interest rates, aggressive marketing to financially vulnerable groups, hidden charges, changes to credit limits, and unilateral change-in-terms provisions.

We will explore how well the bankruptcy system is protecting debtors who have been pushed into bankruptcy due to credit card debt. Part of this inquiry will include an examination of post-bankruptcy conduct by credit card lenders and debt buyers and how that conduct might be subverting the purpose of the bankruptcy law to provide debtors with a "fresh start."

The subcommittee will also touch upon how the 2005 amendments to the Bankruptcy Code, particularly, are affecting such debtors and whether those changes deny bankruptcy relief to those who need and deserve it the most.

Accordingly, I look forward to today's testimony. And I would if Mr. Franks was here recognize him for his opening remarks. I recognize the distinguished Chairman, the venerable John Conyers.

Mr. CONYERS. Thank you, Chairman Cohen. This is an important hearing. One of the things that we are going to look at is credit card practices that have pushed people to the brink of bankruptcy, aggressive marketing to financially vulnerable borrowers.

Do any of you witnesses want to guess how many credit cards my son in his first year at Morehouse has received that I don't know about? I can tell you the ones that I have intercepted, but there are probably some others out there.

Over-aggressive marketing, exorbitant penalty fees and interest rates, that is a scandal in itself. Unilateral changes in terms of the credit card agreements frequently without notice to the borrower.

And then I think that the subcommittee, number 5, can appropriately look at the bankruptcy changes as applies to consumers that were wrought in 2005. You can't hold the Chairman responsible for those.

Means tests indiscriminately blocking debtors from relief without successfully weeding out abuse. Means tests.

Credit counseling requiring added costs, according to the GAO, and may not be all that effective anyway.

Increased filing fees that put bankruptcies out of reach for the very people that might need it.

And finally, can the bankruptcy system handle credit card users who now have unsustainable debt that are hitting the courts in record numbers in the face of a decreased number of bankruptcy judges.

And then finally, the U.S. trustees who should be weeding out creditor abuse with greater effectiveness than they seem to be.

So we welcome you witnesses here.

Mr. COHEN. Thank you, Mr. Chairman. If other Members have statements we will have——

Mr. DELAHUNT. I have a statement.

Mr. COHEN. Yes, sir, the distinguished vice Chairman and Congressman from the Cape is recognized.

Mr. DELAHUNT. The Cape and the islands.

Mr. COHEN. Pardon my sleight.

Mr. DELAHUNT. Chairman Conyers' recount of the problems that currently exist really runs contrary to what was represented to this Committee when the Bankruptcy so-called Reform Act of 2005 was passed. We were told that interest rates would be lowered. We were told a whole variety of practices would no longer occur, and yet that is really not the case.

There was a Business Week magazine story in 2008 that found that the Bank of America sent letters notifying responsible cardholders that it would more than double their rates to as high as 28 percent without providing an explanation for the increase, and to opt out of the card borrowers had to write—the burden was imposed on them to write to the Bank of America that they planned to no longer use their card and instead to pay off the balance at the old rate. In other words, if you read that piece of paper that nobody reads when it comes from the credit card company, you would be aware of that. And when making the decision to raise rates, Bank of America used internal criteria that it didn't make available to the public. How did it happen? And yet when pressed, no information was forthcoming. Talk about opaque, talk about lack of transparency.

As the Chairman knows, I sat with him during the course of multiple hearings over a 6-year period and despite our opposition the Bankruptcy Reform Act passed. And yet nothing has changed except there is more debt on people who can ill afford it. I had hoped that in that agreement, not in the agreement but in the contract of terms and conditions there would have eliminated the provision that says that the credit card issuer can change their terms, other conditions, at any time they want for any reason. Just do it on their own because of some whim or maybe the need for significantly increased products.

So I went out and took a look at a Bank of America contract—not a contract, but the terms and conditions because you can't find the contract. I will get into that later. You have to get the card before they will give you a copy of the contract. It is a new theory. It must be a brand new legal theory. I went to law school many, many years ago, and my memory is, and somebody can correct me, that it required a meeting of the minds. That is very simple. But I did well in contract law and I—you know, things must have changed. But this is recent, and what does it say? This is at the very end of the terms and conditions. My eyesight of course is going, too, along with my memory.

"All account terms are governed by the credit card agreement account, and agreement terms are not guaranteed for any period of time." You have got to remember now this is at the end. This is at the bottom of a lengthy number of pages. "Are not guaranteed for any period of time, all terms, including the APRs and fees, may change in accordance with the agreement and applicable law."

Now, this is really interesting: "We may change them based on information in your credit report, market conditions, business strategies or," and I had this done in red, "or for any reason." Or for any reason.

Let me suggest, Mr. Chairman and Mr. Conyers and to my friends on the other side of the aisle, this is not a good business practice. This is not treating the American consumer in a way that is fair and equitable, and I would submit that it is time and I hope you, Mr. Chairman, with the support of Mr. Conyers and other Members, all of us on both sides of the aisle, take a good hard look at the bankruptcy law and reform the Reform Act of 2005.

With that, I yield back. Thank you.

Mr. COHEN. Thank you. I appreciate it. We now have Mr. Franks here, the distinguished Ranking Member from Arizona, and I recognize him for his opening remarks.

Mr. FRANKS. Thank you, Mr. Chairman. I appreciate the use of the microphone. Without objection, I would like to place the letter from the American Bankers Association in the record would. That be all right?

Mr. COHEN. Without objection.

[The information referred to follows:]

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April 2, 2009

The Honorable Steve Cohen
Chairman, Subcommittee on
Commercial and Administrative Law
House Committee on the Judiciary
Washington, D.C. 20515

The Honorable Trent Franks
Ranking Member, Subcommittee on
Commercial and Administrative Law
House Committee on the Judiciary
Washington, D.C. 20515

Dear Chairman Cohen and Representative Franks:

On behalf of the members of the American Bankers Association, we respectfully request that this letter be made part of the record for the House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law April 2, 2009, hearing entitled, "Consumer Debt – Are Credit Cards Bankrupting Americans?"

Our nation is facing its greatest financial crisis in years, perhaps since the great depression. The credit markets are tight due to increased lending risks, and it is absolutely the worst time to exacerbate our financial problems by enacting changes to the bankruptcy laws that would further contract credit. Should the bankruptcy laws be amended to make it easier to wipe out credit card debt, as has been proposed by some, the market response would simply be to restrict credit, raise interest rates and fees, or both. This would significantly hurt tens of millions of Americans at the very time they can least afford it. In addition, we believe it dangerous public policy to use changes in the bankruptcy laws to create new banking regulations, as the implications of such action may not be well understood. We would strongly urge the Committee to reject going down this path for fear of hurting the very consumers they are trying to protect, as well as the broader economy.

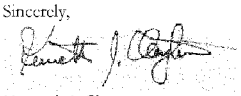
The available evidence from neutral sources plainly shows that credit card debt is not a major cause of bankruptcy. A 2006 study conducted by the Federal Reserve Board at the direction of Congress found that the reasons for filing bankruptcy are complex and tend to be driven by unforeseen events such as job loss, divorce, and uninsured illness, and that there is no evidence of a direct link between increased use of credit cards and the rise in consumer bankruptcy filings. We urge the Subcommittee to not be mislead by advocates claiming such a link as a basis for radical and untested bankruptcy law changes.

There is no doubt that bankruptcy filings have increased recently. But, this is the result of problems in the credit market and deteriorating economic conditions rather than credit card debt. In fact, credit card debt loads have always been a small portion of consumer debt (3.5 percent, according to the 2007 Federal Reserve Survey of Consumer Finances), and increases in credit card debt are reflective of consumer financial needs and not a primary cause of bankruptcy. In these tough economic times, credit cards are

a ready source of credit that can act as a bridge for millions of families, paid back over time, and thus a benefit to consumers rather than a liability. We believe that embracing a policy that unintentionally eliminates such a benefit should not be pursued.

We recognize that our nation faces serious economic challenges, and we want to work with you to assist consumers. However, enacting changes to the bankruptcy laws that would inject more risk and uncertainty into the credit markets by undermining consumer debt is exactly the wrong thing to do at this time.

Sincerely,



Kenneth J. Clayton

Cc: Members of the Subcommittee on
Commercial and Administrative Law

Mr. FRANKS. Mr. Chairman, I apologize for being late. I was dutifully and on time waiting for the hearing to begin in the wrong hearing room. So I appreciate your allowing me to go ahead and give a statement.

I want to welcome our witnesses here and I look forward to an informative hearing.

I have to say sincerely that the title of this hearing strikes me as a little curious. Quote: "Are credit cards bankrupting Americans?" is the title and I am tempted to check my calendar and make sure April Fool's really has passed here because if we are going to believe that credit cards are bankrupting America, I don't know what we won't believe. Credit cards don't bankrupt Americans. They don't. It is that simple. I know that there are accusations that some credit card companies have engaged in some aggressive practices, and, for example, I have heard reports of credit card companies imposing high default interest rates once a credit cardholder has missed a single payment, and I want to hear about credit card company excesses if they are occurring. I think that is a very appropriate topic.

But by and large, the effect of a credit card of the credit card holder is in the credit cardholders hands, literally. It is up to the cardholder in every instance whether to use a credit card to make a purchase. As long as the purchase is within the credit cardholder's credit limit, who is to fault the credit card company for approving the purchase? And once that bridge has been crossed, the cardholder of course owes back the money. If paying back the money is not possible, who is to blame? The credit card company that relied on the cardholder's good faith or the cardholders who knew they were going over the line as they swiped a card, awaited the authorization, and completed the sale? What else are we to do honestly other than to hold a credit cardholder responsible for his or her own decisions?

Should the credit card companies simply not grant credit cards to anyone below a certain income level? Should the credit card companies grant the cards but set everyone's credit limit so low that no one can ever possibly get in trouble? Should they grant cards, set reasonable limits, but then revoke the card at the slightest hint of trouble, demanding immediate payment? Should they leave limits in revocation terms where they are now but make sure that the interest rates, including default interests rates, accurately reflect the risk? Or should they just issue cards under terms that provide them with no protection against risk and stand idly by letting cardholders charge until they file for chapter 7 bankruptcy, watching cardholders pass the chapter 7 means test, and watching bankruptcy courts wipe out the cardholder's unsecured credit card debt?

I mean these are—I am afraid these are the options. And in all seriousness, what are the credit card companies to do and still offer credit cards to cardholders? If that is the last option, I can pretty much tell you that we have seen the end of the days of consumer credit in America.

Now, our distinguishing Ranking Member on the Judiciary Committee, Mr. Smith, has a saying that characterizes the approach of too many lawmakers to too many economic issues these days. He said, it is "punish the successful, tax the rich, and hold no one ac-

countable." I don't know if anything could better summarize what appears to be the effect of the hearing.

So I have to with that, Mr. Chairman, yield back my time.

Mr. COHEN. Thank you, Mr. Franks. I am now pleased to introduce the witnesses, and we look forward to your testimony. I thank everybody for participating in today's hearing. Without objection, your written statements will be placed in the record and we ask that you limit your oral statements to 5 minutes. I think there is a lighting system in this room. Do we have a lighting system? Do you see a green light? There is supposed to be one. Green says you are on for 5 minutes, yellow says you have got a minute left, and red says you are supposed to be finished by then.

After each witness has presented his or her testimony, the subcommittee Members will be allowed to ask you questions subject to the same 5-minute limitation.

Our first witness is Mr. Adam Levitin. Professor Levitin specializes in bankruptcy and commercial law. Before joining the Georgetown faculty, Professor Levitin practiced in the business finance and restructuring department of Weil, Gotshal & Manges, limited partnership, in New York. He also served as Special Counsel for Mortgage Affairs for the Congressional Oversight Panel and as Law Clerk to the Honorable Jane Richards Roth on the U.S. Court of Appeals for the Third Circuit.

Professor Levitin's research focuses on financial institutions and their role in the consumer and business credit economy, including credit card regulation, mortgage lending, identity theft, DIP financing, and bankruptcy claims trading.

Thank you, Professor. I appreciate your testimony and I allow you to go forward.

TESTIMONY OF ADAM J. LEVITIN, ASSOCIATE PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LEVITIN. Good afternoon. My name is Adam Levitin, and I am, as you said, an associate professor of law at Georgetown University Law Center, and a lot of my research focuses on credit cards and bankruptcy.

The first point I wish to make today is that credit card debt is a major factor in consumer financial distress and bankruptcy. While there are good questions, as Representative Franks raised, about why consumers have so much credit card debt, there is no question that credit card debt plays an important role in consumer bankruptcies. The average consumer bankruptcy filer has something on the nature of seven times as much credit card debt as the typical consumer.

To be sure, some of this debt is a function of the macroeconomic problems of the American family. The cost of housing, the cost of health care, the cost of education, these are things that are squeezing American families, and as American families get squeezed and have less and less ability to pay out of their salaries, which have been stagnant, credit card debt is undoubtedly becoming a form of consumer financing.

That said, it is important to know that the relationship between card issuers and consumers is not simply one of the card issuer making a fair offer to the consumer and the consumer having the

ability to take the offer or not. It is not—as Congressman Delahunt was pointing out, this does not look like the traditional contract law meeting of the minds situation; that we have a cardholder agreement that doesn't look anything like one in a law school class would teach as a contract; that if you were to present this to a classroom of first-year law students taking contract law, they would say no, this isn't a contract, this is an illusory agreement, that the cardholder hasn't agreed to anything. They have agreed to whatever the card issuer wants. They can be changed at any time for any reason and even in many cases applied retroactively.

That is not a contract. This cardholder agreement, the form of it, is an essential part of the credit card business model, and the credit card lending business model is not like the traditional lending model, and this is very important. The traditional lender lends out money and expects to get the principal repaid and to make a profit from the interest, and that is a model we have had for thousands of years. We know how it works and it is a core part of capitalism, and it is a model that we should want to see.

The credit card industry has come up with a new and really much more problematic lending model. It is what Ronald Mann at Columbia Law School terms the "sweat box." And the sweat box model does not aim to have the principal repaid. Instead, the sweat box lender lends out some money, the principal, and is hoping to make back enough money in interest and fees that even if the consumer defaults and never pays back that principal, that principal gets discharged in bankruptcy, the lender has still made a profit. If you are able to do sweat box lending, you need to do it with having high interest rates and high fees and by keeping the consumer in that sweat box as long as possible. The longer you can keep him in the sweat box, the more profitable it will be.

And for sweat box lending, you don't have to be super careful about who you lend to. You can lend to people who you know will not be able to repay the principal. And this explains a lot of what we see with indiscriminate credit card lending. That credit card lenders—every credit card loan is a liar loan. We worry about liar loans in the mortgage context, and we have seen what that has wrought. Every credit card loan is a liar loan. There is virtually no income verification for credit cards. Credit cards check—and when you apply for a card, they are going to check your FICO score or something like that, but that only indicates whether you have paid your past bills on time. That doesn't say anything about your assets. It doesn't say anything about your income. It doesn't really tell them much about your future ability to repay.

So we have an industry that is making liar loans, and they are able to do this in part because of the sweat box model, in part because of things like interchange fees, which they get an up-front fee on every transaction; so that is going to cut away on some of the losses on defaults; and in part because securitization structures in credit cards give the issuer all of the upside and only a fraction of the downside risk.

Where does this fit with bankruptcy? The 2005 bankruptcy amendments. One of the chief things about the means test was that it imposed delay on bankruptcy filings, and delay is key because for the sweat box lending it means that the consumer is in

the sweat box lending longer and that means that the card issuer is able to milk out a few more payments and that just adds to the profit even if the principal is never repaid.

So how does the means test add to delay? Well, first of all, the means test means that if you are going to file for bankruptcy you have to have pretty extensive documentation of your income, and that can be a problem for a lot of consumers. A lot of consumers don't keep good records. I am willing to bet that most of the people in this room don't keep extensive past financial records. Yet that is what you need to have if you want to go before a court and get your way and file for chapter 7.

Additionally, and I see that my time is up, the means test adds cost and cost adds delay; that most people when—new research is showing that when people file for bankruptcy it is determined by when they are able to save up enough money to file. And by adding cost and delay, the means test benefits card issuers and supports a lending model that encourages lending to consumers who cannot realistically repay. So the 2005 bankruptcy amendments unfortunately are supporting predatory lending.

[The prepared statement of Mr. Levitin follows:]

PREPARED STATEMENT OF ADAM J. LEVITIN

GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Associate Professor of Law

Written Testimony of

Adam J. Levitin
Associate Professor of Law
Georgetown University Law Center

Before the
United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

Hearing: Consumer Debt — Are Credit Cards Bankrupting Americans?

April 2, 2009

Mr. Chairman, Members of the Subcommittee:

I am pleased to testify today about credit cards and bankruptcy. The credit card is one of the great innovations in the American consumer economy in the 20th century. Credit cards are, in many respects, an excellent product. Credit cards supply consumers with both an extremely convenient payment method and an easy source of financing. Credit cards are the dominant method of consumer financing for everyday purchases.

Credit cards, however, are also a product that can misused by both consumers and card issuers. Consumers can use card irresponsibly, and banks can issue cards and extend credit limits irresponsibly. Unfortunately, credit card business models and product design encourage unsustainable and irresponsible lending that leaves consumers mired in debt and which hurts responsible creditors like small businesses, landlords, tort victims, and the government. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) promotes these predatory business models and product designs, and I urge the Congress to consider repealing key parts of the BAPCPA. I also urge the Congress to consider more comprehensive credit card reform that includes standardization of cardholder agreements and simplification of credit card price structures.

I wish to make four main points in my testimony today:

(1) Credit card debt is a major factor in consumer financial distress and bankruptcy.

(2) Credit card product design and business models are an important factor in high levels of card debt.

(3) The BAPCPA encourages credit card product design that fosters unsustainable credit card lending at the expense of consumers and responsible creditors.

(4) A comprehensive approach should be taken to credit card reform legislation, and part of that approach should be the standardization of cardholder agreement terms and the simplification of credit card pricing. Simplified pricing and standardized terms will allow disclosure to function and make a safer, fairer, and more transparent card market.

I. CREDIT CARD DEBT IS A MAJOR FACTOR IN CONSUMER FINANCIAL DISTRESS

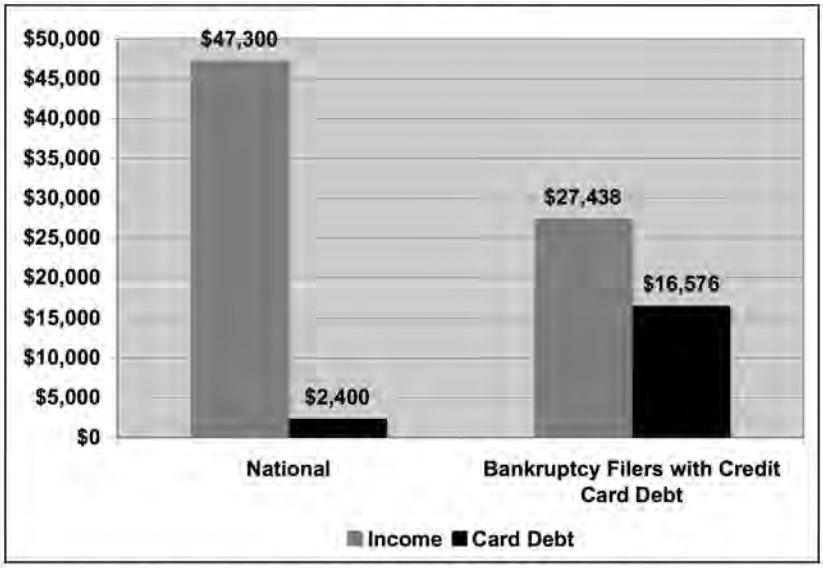
Credit card debt is a major factor in consumer financial distress. Data on credit card use and financial distress is limited, but an examination of credit card debt and bankruptcy filings shows that consumer bankruptcy filers are mired in credit card debt. 87% of consumer bankruptcy filers have credit card debt at their time of filing.[1] In 2007, the median consumer bankruptcy filer with credit card debt had $16,576.00 in credit card

[1] 2007 Consumer Bankruptcy Project. The numbers reported in this testimony are slightly lower than those reported ($17,513.00) in testimony I presented to the Senate Judiciary Committee's Subcommittee on Administrative Oversight and the Courts on a March 24, 2009 hearing. The 2007 CBP oversamples elderly Americans. This testimony presents figures that have been corrected for that oversampling.

debt.[2] This accounted for 18% of the median consumer bankruptcy filer's total debt and 47% of the median consumer's unsecured debt (including taxes, rent, alimony, utilities, medical bills, and student loans).[3] Credit card debt is, after mortgage debt, the largest single obligation of most consumer bankruptcy filers.[4]

To provide some perspective on what $16,576 in card debt means for the median bankruptcy filer, it is 60% of the gross, pre-tax household income of the median filer with card debt.[5] Consumer bankruptcy filers earn less than the median American household, but the $16,576 is still over 35% of the median gross annual national income.[6] The relative severity of credit card debt burdens of bankruptcy filers is evident from Chart 1, which shows levels of credit card debt and gross annual income for the median American household and the median consumer bankruptcy filer in 2007.

Chart 1. Gross Annual Income and Credit Card Debt



It is not clear how much of consumer bankruptcy filers' credit card debt is purchase balances and how much is accrued interest and fees, but if a consumer with $16,576 in credit card debt at an APR of 18%, made no more purchases, incurred no fees,

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[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.* (median annualized gross monthly income of $26,982.00).
[6] Brian K. Bucks, *et al.*, *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, 95 FED. RES. BULL. A1, A5 (2009), *at* http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf (reporting national median income of $47,300.00).

and paid off the debt in five years, the Office of Comptroller of the Currency's recommended amortization period for credit card debt, the consumer would have to make monthly payments of $420.92. These payments would be 18% of the median consumer debtor with credit card debt's gross (pre-tax) monthly income, and 11% of the national median gross (pre-tax) monthly income. For a middle- or lower- income consumer who also to pay taxes and provide basic necessities of food and shelter for her family, this sort of debt burden is near impossible. Few consumers can service high interest rates like credit card default rates from their disposable income, let alone make any headway in paying down the principal. Not surprisingly, 52% of consumer bankruptcy filers list credit card debt as a major factor in their bankruptcy.[7]

The precise dynamics of credit card debt and financial distress are not well understood. While Professor Ronald Mann has shown that dollar for dollar, a consumer with credit card debt is more likely to file for bankruptcy than a consumer with any other form of debt,[8] it is not clear whether card debt generate financial distress in the first instance or whether consumers in financial distress turn to cards as a source of short-term financing. In either case, however, credit card debt certainly contributes to financial distress as the interest and fees on card debt amounts faster than consumers can pay it off. Credit cards amplify existing debt burdens, and for many families this means credit cards are financial quicksand.

There are several factors underlying high levels of credit card debt: the macroeconomic strain of the American family; irresponsible spending; and credit card product design. High levels of credit card debt reflect the deeper economic problems of American families: the costs of health care, education, and housing.[9] These basic costs of living have increased dramatically in recent decades, while incomes have remained stagnant. Savings rates have plummeted to zero or even negative, and home equity, the largest single asset of many families, has been depleted. Household finances have been stretched thin by increased costs of living and stagnant incomes. This means there is no cushion left for middle class families faced with unpredictable shocks to their income like death, illness, divorce, or unemployment. Many American families are forced to finance basic expenses off of cards in order to maintain the same middle class standard of living. To be sure, there are some individuals who borrow lavishly and irresponsibly on their credit cards to support a lifestyle far beyond their means, but these are the exception, not the rule; macroeconomic pressures on the American family are the primary driver of card debt.

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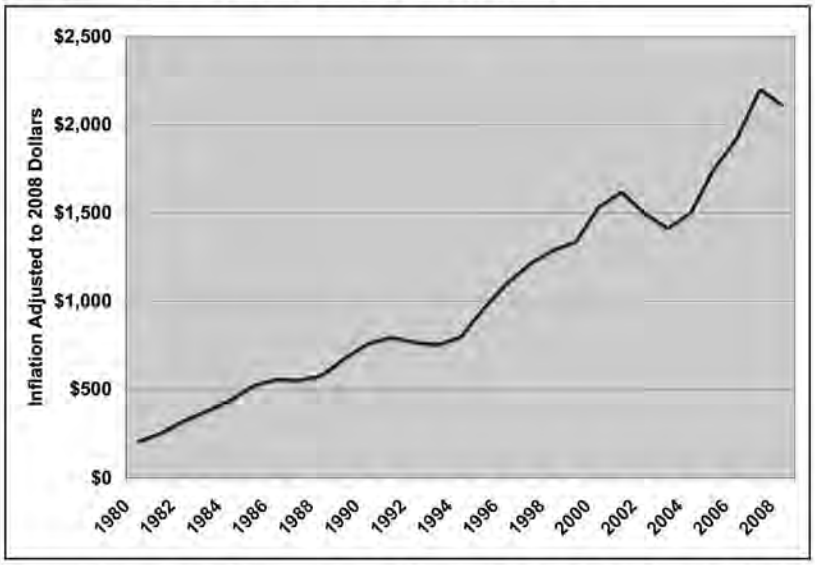
[7] 2007 Consumer Bankruptcy Project Database.

[8] RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS (2006).

[9] ELIZABETH WARREN & AMELIA WARREN-TYAGI, TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE 180 (Basic 2003). It is also important to note that but for the mortgage bubble, Americans would like be mired far more deeply in credit card debt. During the mortgage bubble, many households did cash-out refinancings of their mortgages and used the cashed-out home equity to pay down credit card debt. At the time, with a rising housing market this seemed quite sensible. For example, a household might have paid off $20,000 in credit card debt at 20% APR by refinancing it into a 9% APR mortgage. The mortgage bubble thus eased credit card debt burdens. Now that the bubble has popped and the home equity piggybank is empty, hard stretched American families are again turning to credit cards to finance daily expenses.

Card debt is the Scotch tape holding together the middle class. Unfortunately, for many families, it also exacerbates their financial distress. Simply servicing credit card debt is a major strain for American families. As Chart 2 shows, even in inflation adjusted dollars, the amount of interest US households pay on revolving debt (almost all of which is credit card debt), has grown significantly and is now at over $2,000/year, or over 4% of gross annual median income. These high levels of credit card debt also discourage savings for future contingencies and retirement.

Chart 2. Interest Paid on Revolving Debt Per Household



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Products Accounts, Table 2.1.1, Line 29.

II. CREDIT CARD PRODUCT DESIGN AND BUSINESS MODEL FOSTER HIGH LEVELS OF CARD DEBT

While credit card debt burdens are in part a function of the macroeconomic problems of the American family, they are also a function of credit card product design. Credit card product design makes it possible to lend profitably even to high risk consumers. A traditional creditor lends money with an eye to recovering its principal and making a profit from the interest. Such a lender cannot lend to overly risky customers, as loss of principal is devastating to its business model. As a result, a traditional lender will engage in robust underwriting of its loans.

Credit card issuers hardly engage in robust underwriting; credit cards are almost all stated income loans, which have come to be better known as "liar loans," in the

mortgage context. While card issuers will look at credit scores and credit reporting information, this is extremely thin as underwriting goes—there is no validated information on income and assets or non-credit-reported debts.

A. The Sweatbox Lending Model

Card issuers are able to engage in unsecured stated-income lending because many employ a non-traditional lending strategy, one that Professor Ronald Mann of Columbia Law School has termed "the sweatbox." Sweatbox lending does not require return of the principal. Instead, the sweatbox lender makes enough money off of interest and fees that even if it losses the principal, it will still make a handsome profit.[10] Thus, a sweatbox lender will be willing to make loans that are unsustainable in the long run, so long as it can extract sufficient profit before the consumer defaults. As explained by Julie L. Williams, then the Acting Comptroller of the Currency, "Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset…it's not repayment of the amount of the debt that is the focus, but rather the income the credit relationship generates through periodic payments on the loan, associated fees, and cross-selling opportunities."[11]

Credit card price structures are a key part of the sweatbox model. Credit cards not only have high interest rates, but they have extremely high back-end fees that are unrelated to costs, such as late fees and overlimit fees, plus a host of billing tricks and traps that function as hidden price points. Tricks and traps directly generated over $12 billion in revenue for the card industry in 2007,[12] which was over 30% of the industry's pre-tax profits.[13] By shifting the cost of credit away from prominent, up-front price points like purchase APR to back-end fees and penalty APRs and billing tricks and traps, card issuers encourage greater use of cards, thereby increasing the number of consumers who enter the sweatbox.

B. Interchange Fees

Several other features of credit card product design also encourage riskier lending. Increasingly, the card industry's business model is fee-based, not interest based. Unfortunately, just as with subprime mortgages, the fee-based business model creates a perverse incentive to lend indiscriminately and ignore delinquencies.

Card issuers make money on every credit card transaction, regardless of whether the consumer ultimately pays a finance charge. The issuer receives around two percent of every transaction in a fee paid by the merchant (and passed on to all consumers in the

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[10] *See* Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 392-97 (2007).

[11] Remarks by Julie L. Williams, Acting Comptroller of the Currency, Before the BAI National Loan Review Conference, New Orleans, LA, March 21, 2005, *at* http://www.occ.treas.gov/ftp/release/2005-34a.pdf.

[12] Comment Letter 177, Unfair or Deceptive Acts or Practices (2008-0004), from Oliver Ireland, Partner, Morrison & Foerster LLP, dated August 7, 2008, *available at* http://files.ots.treas.gov/comments/bdc5cc5c-1e0b-8562-eb23-ff7159e49505.pdf. The letter does not address on whose behalf Mr. Ireland is writing, but Mr. Ireland is a prominent credit card industry lobbyist..

[13] CardData.com (subscription data source).

form of higher prices), called the interchange fee.[14] Card issuers will collect about $48 billion in interchange fees this year.[15]

Because interchange is based on transaction volume, it creates an incentive for banks to issue as many cards as possible, with little regard to the creditworthiness of the borrower. By creating a huge revenue stream unrelated to credit risk, interchange encourages card issuers to engage in less careful underwriting.

C. Securitization

Banks have compounded this problem by shifting much of the loan risk to investors through securitization. When card issuers securitize credit card debt, they transform the credit card debt into a pool of assets used to pay off bonds. If the pool turns out not to be large enough, the bond investors take the loss. But if there's a surplus, it goes to the card issuer.

To illustrate, credit card securitization deals typically require that the card issuer retain an untranched 7% stake in the securitized pool. Many issuers will keep a higher stake. Suppose an issue has a 15% stake in a pool and the pool needs to pay $100 million in bonds. If the pool generates revenue of $110 million, the card issuer gets $25 million ($10 million in excess spread + 15% of $100 million). If the pool only generates $90 million in revenue, however, the card issuer losses only $1.5 million (15% of $10 million in losses).

Because the card issuer retains control of the terms of securitized accounts, it can easily increase their volatility by applying and increasing penalty interest rates and fees. Some consumers will default as a result of higher rates and fees, but others will simply pay more. Because the card issuer has all of the upside and only a fraction of the downside, there is an incentive for the card issuer to crank up the interest rates and fees. For example, if a card issuer normally has a 5% default rate for an average balance of $100, it can expect revenue of $95. If the card issuer raises interest and fees so that average balances go up to $110, even if default rates go up two and a half times to 12.5%.

While card issuers sell off most of the default risk, they keep any upside that comes from inflating their fees and rates. If the higher fees and rates cause more defaults, it is investors who bear the loss. If the higher fees result in more income, however, it is the card issuer, not the investors, who benefit. Credit card securitization creates a heads I win, tails you lose situation and leads the banks to increase fees and interest rates on securitized debt. Interchange and securitization thus make it possible for card issuers to engage in less careful underwriting, which allows them to apply the sweatbox to even more consumers, including ones who are less economically stable.

D. Sweatbox Lending and Bankruptcy "Reform"

All lenders lend for profit, of course, but a lender who lends with an eye to getting its principal repaid and making a profit from the interest is a very different type of lender than one who lends with an eye to turning the consumer into a "perpetual earning asset."

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[14] Technically, the interchange fee is the fee paid by the merchant's bank to the issuer, but this fee is simply passed along to the merchant as is the bulk of the "merchant discount fee." *See* Levitin, *supra* note **Error! Bookmark not defined.**.

[15] Merchants Payments Coalition.

No matter how greedy a lender is, a lender that is looking to get back its principal, cannot squeeze a consumer too hard lest it push the consumer into default. A lender that doesn't care about getting principal repaid, as much as about extracting maximum payments from the consumer will squeeze much harder. This business model resulted in things like the "interest only" and "pay option ARM" mortgages that are currently wreaking havoc on the economic. It is an inherently reckless business model because even if lenders do not want consumers to default, they lack sufficient information to make sure that they do not end up pushing the consumer into default. The sweatbox lending model is predatory and unsuited for sustainable lending.

There are two keys to making the sweatbox lending model work. First, the "heat" must be high enough—interest rates and fees must be lathered on. Card issuers have shown that they are expert at this. And second, the consumer must be kept in the sweatbox as long as possible. As Professor Mann has observed, the longer the consumer can be kept in the sweatbox of making minimum payments that exceed the cost of funds before eventually defaulting, the more profitable the loan. Bankruptcy is an escape hatch from the sweatbox. Thus, anything the lender can do to delay the default, such as making it more difficult to file for bankruptcy, allows the lender to extract greater revenue from the consumer.

The aim of keeping consumers in a lending sweatbox for as long as possible explains key parts of the BAPCPA, in particular the means test and credit counseling requirements.

III. THE BAPCPA BENEFITS CREDIT CARD ISSUERS AT THE EXPENSE OF DEBTORS AND OTHER CREDITORS

The centerpiece of the BAPCPA was the "means test" that determines which consumers are eligible for filing for Chapter 7 bankruptcy. The means test is a rubric for a complex statutory provision regarding whether a rebuttable presumption of abuse exists for a consumer debtor to file for Chapter 7 and who can raise the presumption. If a consumer bankruptcy filer's adjusted income is too high, then a presumption of abuse exists against the consumer. If the debtor's filing is found to be an abuse of Chapter 7's provisions, then the case must be dismissed or converted to Chapter 13 or 11.

Whatever one thinks about means testing as a general policy matter, there is broad consensus that the current means test is poorly drafted and ineffective. There has been no noticeable impact on the income of consumers filing for bankruptcy before or after the 2005 amendments; the median income and the distribution of income of bankruptcy filers in 2001 was virtually identical to filers in 2007.[16] As the most recent empirical study of the impact of BAPCPA on bankruptcy filings notes, "instead of functioning like a sieve, carefully sorting the high-income abusers from those in true need, the amendments' means test functioned more like a barricade, blocking out hundreds of thousands of struggling families indiscriminately, regardless of their individual income

[16] Robert M. Lawless, *et al.*, *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 358-63 (2008).

circumstances."[17] This is not what the bill was marketed as doing. It "was not the Bankruptcy Numbers Reduction Act; it was the Bankruptcy Abuse Prevention Act."[18]

The credit card industry's goal with the 2005 amendments, however, was not to sort out can-pay debtors or to extract greater payouts in bankruptcy. Instead, the card industry sought to delay bankruptcy filings. Delayed bankruptcy filings boost credit card industry profits. The 2005 amendments, in particular the documentation required for means testing and the requirement of pre-bankruptcy credit counseling, add delay directly to the filing process. They also encourage delay for debtors who wish to avoid the abuse presumption of the means test; it is relatively easy for a debtor to game the means test, but to do so requires delaying a filing by some months. And the 2005 amendments add cost to the filing process, and cost adds further delay, as many consumers file for bankruptcy not because of an exigent need, like to prevent a mortgage foreclosure, but when they have saved up enough money to file.

Because bankruptcy distributions on unsecured debt are made pro rata, delayed filings benefits creditors, like credit card issuers, with higher interest rates. Their claims grow relatively faster than unsecured creditors who charge no or low rates of interest, such as tort claimants, medical bills, landlords, local merchants and small businesses, and federal, state, and local government. Because distributions on unsecured debt are made pro rata, it is a zero sum game; to the extent that card issuers' claims are larger because of delay it comes at the expense of other creditors.

This can be seen when one compares pre-BAPCPA debt burdens of bankruptcy filers to post-BAPCPA debt burdens. From 2001 to 2007, median secured debt rose 20.8% and median unsecured debt (primarily credit cards) rose 43.6%.[19] Delayed filings only leave debtors more deeply mired in debt (not all of which is dischargeable, thus limiting the potency of the bankruptcy "fresh start"), and may delay filings past the prudent point. The delay comes at the expense of creditors who charge more manageable rates of interest. And means testing adds a significant burden to the court system. Whatever one thinks of the policy of means testing and related measures supposedly designed to prevent bankruptcy "abuse," they have been unsuccessful on their own terms; BAPCPA has delayed and kept down bankruptcy filings in general, rather than screened out abusers.[20] The abuse prevention measures in BAPCPA were also unnecessary; the Bankruptcy Code already gave creditors the ability to challenge debtors' discharges,[21] but credit card issuers rarely litigated under these provisions.

Eliminating the means test and credit counseling requirements for bankruptcy filers would make it cheaper and simpler to file for bankruptcy and would discourage card issuers from sweatbox lending that pushes many consumers into bankruptcy and exacerbates the economic problems of the already-stretched American family.

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[17] *Id.* at 353.
[18] *Id.* at 352.
[19] *Id.* at 368.
[20] *Id.* at 352.
[21] 11 U.S.C. § 523(a)(2).

IV. SUGGESTIONS FOR CREDIT CARD REFORM LEGISLATION

A. The Need for Comprehensive Card Reform Legislation

Credit cards play an important role in the American economy, but they also cause significant problems and exacerbate others. The current financial crisis underscores the important of consumer protection for the health of the entire economy, and the Congress has rightly taken a keen interest in credit card reform legislation. The credit card reform legislation that has been proposed, however, takes a piecemeal approach. There are bills that deal with billing practices, with bankruptcy, with interchange, with usury, and with establishing a federal financial product safety commission. These are all important issues, but they are also intertwined. Therefore, I urge Congress to consider taking a comprehensive approach to credit card reform legislation. Issues like bankruptcy, billing practices, interchange, securitization, and usury are all intimately linked, and would be best addressed comprehensively, rather than piecemeal.

B. Limitations with Current Approaches to Credit Card Regulation

I would also urge the Congress to recognize that the there are significant drawbacks to the two primary methods of card regulation used to date: disclosure regulations and substantive regulations.

1. Disclosure Regulation

Disclosure has been the primary paradigm for card regulation since the 1968 Truth-in-Lending Act. Unfortunately, there is no evidence that it works for complex financial products like credit cards. While disclosure is effective for simple financial products where consumers can compare one or a few price terms, it cannot work for credit cards. Credit cards are different from virtually every other consumer financial product in their complexity. Most consumer credit products, such as auto loans, mortgages, and student loans have only one or two price points. These price points do not vary except in relation to an objective index, such as the Federal Funds Rate or LIBOR. Unlike other common consumer credit products, however, credit cards have an astounding array of price points: annual fees, merchant fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, overlimit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees, etc. These are all explicit prices points, disclosed in Truth-in-Lending schedules.

The sheer number of explicit prices points that make it difficult for consumers to accurately and easily gauge the total cost of using credit cards.[22] Consumers are not capable of doing the on-the-spot calculations necessary to figure out whether or not to use any particular credit card for any particular transaction. There is too much information that the consumer must process. Even if the consumer could process all this information, it simply would not be worthwhile to do for every transaction. The burden this would impose would negate all of the convenience benefits credit cards have for consumers.

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[22] Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 19.

Consumers' difficulty in determining the cost of credit cards is compounded by credit cards' hidden price points in the form of billing practices, such as universal cross-default, unilateral term changes, residual interest, two-cycle billing, unlimited overlimit fees, application of payments to the lowest interest rate balance, non-standard use of terms like "fixed rate" and "Prime rate," and unclear policies as to precisely when a payment is due. These billing practices make credit card pricing to vary based not only on objective indices, but also on the card issuers' subjective whim. Credit card billing practices alter the application of the explicit price points and make the effective cost of using credit cards higher than disclosed. These billing practices further obfuscate the true cost of using credit and make it virtually impossible for a consumer to make a fully informed decision about whether to use credit and, if so, which credit card product to use.

2. Substantive Regulation

Substantive regulations, like usury laws and unfair and deceptive acts and practices (UDAP) statutes are able to address specific egregious card industry practices. Strong substantive regulations can have the unintended consequences of product substitute and credit rationing. But even more limited substantive regulation can result in term substitution: card issuers will simply substitute new terms for the regulated ones. Thus, legislating against specific practices inevitably devolve into a game of regulatory Whac-A-Mole: every time regulators put the kibosh on one practice, the card industry invents another to take its place. The card industry has shown itself to be remarkably resourceful in engineering its products around regulation. Congress will always be playing catch-up in this game of regulation and innovation. A dedicated federal regulatory agency, like a consumer financial product safety commission would be able to move faster than Congress, but even then it might not move fast enough.

C. A New Approach to Card Regulation: Standardization and Simplification

The only sure way to stop negative innovation in the card industry is to flip the regulatory model on its head. Currently card issuers are allowed to do anything, except specific prohibited practices. The better regulatory structure would be to prohibit anything, except for specific permitted practices. Such a regulatory model could be combined with a mandatory simplification of credit card price structures. All of credit cards' myriad price points can be boiled down into three price terms: an availability fee, a transaction fee, and an interest rate. Congress would do well to mandate that these and only these three fees may be charged by card issuers, and to require standardization of key cardholder agreement terms, just as is currently done with insurance policies. Card issuers would be free to compete and price as they wish within this focused structure.

The benefits of mandating standardization and simplification of credit card price structures are that consumers would be able to easily and simply compare cards on an "apples-to-apples" basis that would give them the entire picture of the costs involved with a card. There would be no worries about the fine print and no hidden fees or price points designed to take advantage of consumers' tendency to overestimate their future ability to repay and underestimate the costs of delayed fees and interest.

While standardization would come at the price of some product differentiation, the variation among credit cards currently is insignificant—consider Capital One's present advertising campaign, which touts the special feature of Capital One's cards: that

a cardholder can choose the picture that goes on the card. Instead, what one would expect to emerge would be a (much-needed) bifurcation to occur in the card market. There should emerge a market for cards aimed at transactors and another aimed at revolvers. Those aimed at transactors, would feature high interest rates, but low per transaction fees, while those cards aimed at revolvers would have higher transaction fees, but lower interest rates.

None of this would solve the problem of consumers' inability to accurately predict whether they would revolve or merely transact, and many consumers alternate between the two. But by simplifying card pricing structure, consumers would be able to at least pick the lowest cost card in either category, and this would push down interest rates (and eliminate back-end fees). Without inefficiently high interest rates and back-end fees, the sweatbox lending model cannot work, and the card industry would have to go back to safer, more sustainable, and non-predatory traditional lending models.

I urge the Congress to take up a comprehensive program of credit card reform legislation. While repealing parts of the BAPCPA is a key element to creating a fair and sustainable card lending industry, that alone will not eliminate predatory lending models. Instead, I strongly urge the Congress to consider mandating term standardization and price structure simplification for credit cards.

Mr. COHEN. Thank you, Mr. Levitin.

Our second witness is Mr. David John. I understand Mr. John and Mr. Mierzwinski have to leave a little early? Mr. Weiss? Okay. Thanks. I hope it is not because you have to get to the post office to get your credit card paid, but whatever it is.

Our second witness is Mr. David John. Mr. John is a Senior Research Fellow, Thomas A. Roe Institute for Economic Policy Studies of the Heritage Foundation. He has been published and quoted extensively in many major publications. He has also appeared on many other national and syndicated and radio and television shows regarding Social Security reform and retirement issues.

Mr. John came to the Heritage Foundation from the Office of Representative Mark Sanford of South Carolina. He was the lead author of Sanford's plan to reform Social Security by setting up a system of personal retirement accounts. His Capitol Hill service also includes stints in the offices of Representatives Matt Rinaldo of New Jersey and Doug Barnard, Jr. of Georgia. In the private sector he was Vice President at the Chase Manhattan Bank in New York, specializing in public policy development. In addition, he worked for 3 years as Director of Legislative Affairs at the National Association of Federal Credit Unions and worked as a Senior Legislative Consultant for the Washington law firm of Manatt, Phelps & Phillips.

Thank you, sir.

TESTIMONY OF DAVID C. JOHN, SENIOR RESEARCH FELLOW, THOMAS A. ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION

Mr. JOHN. Thank you for having me. I am not here to defend credit card companies. As a matter of fact, I have had my own bad experiences with them. I was overseas a few years ago and was 24 hours late on a payment and got hit by a whopping fee and a rather substantial increase in my credit card rate. So this has not been, shall we say, a universally delightful relationship with my credit card company, and I only carry one.

However, there are ways to deal with the issue and there are some proposals out there which actually would make things worse and would tentatively hurt the very individuals that I believe that most of the Members of this Committee most want to help achieve financial stability.

Credit cards are expensive to operate. They are incredibly complex. Last Monday or 3 days ago I was at Heathrow in London flying on my way back to the U.S. and, needing a book for the flight, I went into a bookstore, pulled out my Visa card, and the transaction was approved in about 3 seconds or so. The intricate hardware necessary for such a transaction, not to mention billing me, et cetera, and it has already shown up on my record, is not something you can put together very quickly or very easily. I would argue that most of the problems that we are going to hear and have heard about have actually already been dealt with. They have been dealt with by regulations the Federal Reserve Board issued in December of this last year. They were also issued by the Office of Thrift Supervision and the National Credit Union Administration. And what these changes do is, among other things, make very

comprehensive changes to the credit card statements, not the least of which making it very clear how long an individual will pay to pay off their balance if they only pay the minimum. It will also include a series of new consumer protections. It will include limitations on up-front fees, a longer period between the time that the statements are mailed and the payments are due, a 45-day notice period before higher rates come into effect, et cetera. And it bans explicitly certain of the practices that have been most a problem with the credit card industry. These include increasing rates on current balances and certain future balances, the idea that you would be paying off lower interest rate credit before you would be paying off higher interest rate credit, double billing cycles, et cetera, et cetera, et cetera.

Now, these regulations which were developed extensively after long discussions with consumers and testing with consumers, and the like, are specifically aimed at solving the problems that the credit card industry has faced. And I believe that if you look at them, you will find that they basically answer virtually all of the problems that you are going to have raised today. However, there has been some complaint by the fact that they won't go into effect for 18 months or so, and the reason for that is very simple, because it takes a long time to reprogram computers, retrain staff, et cetera. The last thing that you would want given the fact that there are penalties of up to a million dollars a day for violating those regs is to have someone on your staff give somebody the wrong information and therefore find yourself liable for that penalty.

If you look at the bankruptcy laws that have been passed in 2005, for instance, you can look at the means test, and one proposal that came out would basically exempt anyone from the means test who has one high interest loan. What I am most worried about here is the fact that lower income customers, first-time borrowers, and people who have impaired credit histories need to rebuild their history. If you build the cost of the credit card industry too much, these are people who are going to simply find themselves closed out of new credit and they are going to be forced to go to the check cashing agency down the street or some other low reputable borrower—or lender. Excuse me. This would be a serious mistake. The last thing you want to do is to take some sort of action that makes the problem worse for the very people that you should be interested in helping.

Thank you.

[The prepared statement of Mr. John follows:]

PREPARED STATEMENT OF DAVID C. JOHN

CONGRESSIONAL TESTIMONY

Credit Cards and Consumer Debt

Testimony before
Subcommittee on
Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

April 2, 2009

David C. John
Senior Research Fellow
Thomas A. Roe Institute for Economic Policy Studies
The Heritage Foundation

Thank you for the opportunity to testify before you today on ways to best change certain credit card practices without damaging the ability of moderate to lower income consumers to get essential credit. My name is David John. I am Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Let me make it clear from the start that my purpose today is not to defend in any way abusive credit practices. I find them as abhorrent as others who are testifying this afternoon. However, I also believe that there is a limit to what Congress should do as opposed to having the Federal Reserve and other regulators handle the issue. While detailed legislation on credit card practices may make legislators feel that they have resolved a tricky issue, the wrong approach is far more likely to make the situation for low and moderate income workers in need of credit even worse than it is now.

The credit card industry clearly needs reform. As other witnesses will discuss, a number of practices have developed which are clearly unfair to consumers. However, a legislative remedy for those practices could both be mistaken and detrimental to lower and moderate income borrowers, first time borrowers, and those seeking to repair their credit histories. In addition, the jurisdiction for such legislation lies with the House Financial Services Committee and the Senate Banking Committee. In the Senate, there is one bill, S. 257, the Consumer Credit Fairness Act, which does fall under the jurisdiction of that chamber's Judiciary Committee. However, as I will discuss below, that legislation is badly flawed, and could cause far more problems than it resolves.

The best approach to the problem of abusive credit card practices has already born results. On December 18, 2008, the Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration released regulations that will ban most if not all of the abusive practices that will be discussed here. These regulations will greatly increase consumer protections, change the internal practices of issuers, and alter pricing. Violating the rules will carry a penalty that could reach $1 million a day. They were the result of four years of work that included extensive comments, consumer testing, and

other work to ensure that the rules did affect the very practices before the subcommittee today.

Among the many changes imposed by the new regulations are:

- Comprehensive changes to credit card statements to ensure that consumers both have and can understand the terms of their cards, what their balance is and how much they need to pay each month, the consequences of late payment, and information about how long it will take the consumer to pay off the balance if he or she just pays the minimum each month. The regulations are very specific on the layout of the new statement, the language used, and the information provided.

- New consumer protections that include limitations on up front fees, a longer period between the time that statements are mailed and payments are due, and a 45 day notice period before higher rates can come into force. These protections and others were specifically targeted to respond to the complaints consumers made.

- Many abusive practices are banned. These include increasing interest rates on both current balances and certain future balances, paying off low interest rate credit first and higher credit rate purchase only after the earlier balances have been paid in full, and double cycle billing. Again, the regulations target the explicit practices that consumers most complain about.

As with all such changes, these regulations will have an effect on the availability of credit to customers with less than perfect credit histories. While credit cards will be cheaper for many customers, others will find it harder to get them. This is likely to force some customers to other types of lenders, and deny credit entirely to others.

Some have complained about the delay in implementating the new regulations. This impatience is understandable, for the practices being banned are often detestable. However, given that the affected companies will need to reprogram computers, completely redesign credit card statements, and retrain employees, the delay can be justified. Legislation is unlikely to speed the process to any appreciable extent.

In addition, legislation bears its own risks. The simple fact is that in situations like these, regulations are easier and faster to adapt t cover new abuses that may develop over time. Given that in any business it is likely that someone will seek additional profits by circumventing the rules, an alert regulator is likely to catch and deal with the situation long before legislation could be amended to catch it.

One approach that some legislation has taken is to attack high interest lenders under the belief that defining certain interest rates as abusive could have the perceived benefit of affecting both some credit card issuers and other types of lenders. The bill that I referred to in the Senate, S. 257, seeks to deny any high interest debt as defined in the bill the ability to receive any relief in a bankruptcy filing. Supporters of this approach believe that reducing the impact of high interest lenders cannot be anything but beneficial for their customers.

Unfortunately, economic literature on the economic effect that high interest lenders have on their customers is spotty, with many studies as interested in proving a point as in objective research. Activists take it for granted that there is a "debt trap" where customers of high interest lenders find themselves deeper and deeper in debt to the lender as interest rates and fees combine to make it impossible for them to repay their loans. Such a trap may well exist in both specific cases and in general. However, there is research from the New York Federal Reserve Bank[1] which suggests that the debt trap may not exist in all situations, and in fact some consumers may be better off with the presence of high interest lenders than they are without them. This paper looks at Georgia and North Carolina after payday lenders were banned, and found higher incidences of bounced checks, complaints about the collection methods of lenders and bankruptcy filings after the ban than before it. This suggests that high interest lenders meet a definite need, and raises questions whether a too stringent approach to credit card practices may end up causing more problems than it solves.

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[1] Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans", Federal Reserve Bank of New York Staff Report no. 309, November 2007 revised February 2008, at:

The first question is who would be the affected borrowers. While it is clear from many data sources that individuals from any and all socio-economic levels can be customers of high interest lenders due to either sudden income shocks or poor financial management skills, the largest proportion of customers fall into three groups. These are low-to-moderate income workers who have limited access to other credit sources either because of low income, poor credit histories, or the simple fact that few banks and other lenders have branches that are easily accessible to these consumers. Second are first time borrowers who may have high potential to become good credit consumers, but for now have no credit history and no one willing to co-sign their loan application. Finally, there are consumers who have poor credit histories or who may have just emerged from bankruptcy, and are seeking to rebuild their credit records.

Credit products are primarily priced by the risk of the customer. Thus, customers with either poor credit histories or none at all, can expect to pay significantly higher interest rates than those with better credit records. The high interest rates cover significantly higher chance of default along with much higher collection costs. However, these high rates are usually temporary. As new borrowers demonstrate their ability to responsibly handle credit, they qualify for lower and lower interest rates, often by switching lenders. The same is true for borrowers with poor credit records who are seeking to restore their reputations.

While it may seem that legislation such as S. 257 would encourage lenders to reduce their interest rates to these borrowers so that they will fall below the caps in this legislation, it will not. For responsible lenders who base their interest rates and fees on the risk that the borrower will either not repay the loan or that it will require extensive contact with him or her to get payments, a very costly process, the added risk that such products will not be recoverable in bankruptcy will simply result in their withdrawing from the market. The products will become too risky for reputable financial institutions to offer.

Certain other reputable lenders will continue to offer products to these borrowers, and may even lower their fees, but they will increase the requirements to qualify for such

loans in a way that will reduce the number of potential customers. The combination of higher credit standards and fewer credit providers will leave high risk borrowers with either no credit available, or force them into the hands of less reputable lenders.

Some less reputable lenders will react to the inability to recover high interest loans in bankruptcy by raising their fees even higher so that they can make their profits faster. Their customers will not find any relief from the passage of this bill. Other even less reputable lenders, who never use the legal system for collections in the first place, will be delighted if the result of this legislation is a rise in the number of consumers forced to use their services.

The sad fact is that changing the interest rates charged for high risk loans is very unlikely to change the demand for them. This is especially true in hard economic times when record numbers of Americans are already losing jobs, having their hours of work reduced, or for other reasons finding it ever harder to meet their financial obligations. At the same time financial institutions are raising credit standards so that fewer and fewer customers qualify for their lowest rate products and raising both fees and interest rates for riskier customers and in many cases cancelling the credit lines of higher risk customers. All of these actions simply serve to increase the demand for higher cost credit products.

These tighter credit standards are likely to last for some time. In addition, recent massive increases in the money supply and federal spending may result in renewed inflationary pressures, which will further increase interest rates. This is where the specific language of bills like S. 257 could cause additional problems.

The bill's definition of "high cost credit consumer transactions" is too broad and could encompass transactions that no one regards as usurious, especially as regards "costs and fees". This would subject more lenders to having their loans disallowed when borrowers file for bankruptcy – perhaps, in some cases, to that lender's great surprise. The bill's definition specifically includes any credit transaction where the combination of interest rate and fees exceeds "at any time while the credit is outstanding" the sum of 15 percent plus the yield on 30-year Treasury bonds.

Under this definition, a traditional 30-year mortgage issued in October 1981 when mortgage interest rates peaked at an 18.45 percent annual percentage rate came under the bill's definition as a "high cost credit consumer transaction" in December of 2008, when the interest rate on 30-year Treasury bonds dropped to 2.87 percent. Depending on fees paid during closing, it may have come under the bill's definition well before then.

The bill's definition is even more stringent than that contained in the last Congress' H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act of 2007, which limited its reach to loans where the rate exceeded a spread over a Treasury bond rate on "the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor." S. 257's open ended liability places any fixed rate loans made during periods of high inflation at risk of being considered as high cost credit and being inexcusable under bankruptcy.

Other areas of the bill are also troubling. By granting a bankruptcy filer "who has any debts arising from a high cost consumer credit transaction" relief from requirements that those who have sufficient income to repay some of their debts must do so before receiving a discharge, this language invites gaming of the system. A prospective filer could take out a small, high-interest-rate loan for the express purpose of getting into Chapter 7 rather than Chapter 13 and thus avoiding any obligation to repay from future income. Such a loophole would provide hundreds of new customers for the very lenders that proponents claim to oppose, some of whom might be directed to the lenders by less reputable bankruptcy attorneys. This provision effectively guts the 2005 bankruptcy reforms.

In conclusion, legislation like S. 257 is unlikely to reduce high interest rate lending. Indeed, this is true of just about any legislative approach to this issue. All that it is likely to do is to either make it harder for certain populations to find credit at all, or to make it even more expensive for them to do so. The sad fact is that the customers of such lenders only utilize them because those customers have no other choice. The demand for those credit services will be there no matter what the cost. Any bill which is essentially a price cap or attempted prohibition is not likely to reduce that demand at all.

Mr. COHEN. Thank you, sir. I am going to move to Mr. Weiss just in case there is a time limit.

Mr. Brett Weiss is our next witness. He currently heads the Bankruptcy and Insolvency Group at Joseph, Greenwald & Laake, a Greenbelt, Maryland firm founded in 1968. He has experience in chapter 7, 11, 13, and chapter 11 for business reorganizations. He has represented individual and corporate debtors and creditors in all phases of bankruptcy. He has received international media attention in connection with the bankruptcy cases that he has been involved in. He is an experienced litigator, having been involved in a number of cases of first impression concerning debtor and creditor rights.

Mr. Weiss, I appreciate your testimony.

TESTIMONY OF BRETT WEISS, ATTORNEY, GREENBELT, MD, ON BEHALF OF THE NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Mr. WEISS. Thank you. Chairman Cohen, Mr. Franks, Mr. Conyers, Members of the Subcommittee,good afternoon. I am Brett Weiss, a bankruptcy attorney from Greenbelt, Maryland. I appear today on behalf of the National Association of Consumer Bankruptcy Attorneys, NACBA, which is the only organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. NACBA currently has more than 3,700 members in all 50 States and Puerto Rico.

I appreciate the opportunity to speak with you about an issue I hear about a lot from my clients: unfair and abusive credit card practices that drive them into bankruptcy. As a bankruptcy attorney, I have been helping people with money problems for over 25 years. I have seen thousands of honest, hardworking, smart people fall into hard times due to three main reasons: medical issues, job problems, and divorce. These people don't charge big screen TVs and expensive vacations to their credit cards. They charge medicine and food and gas to get to work and then find that the deal they thought they had with Visa or MasterCard was built on sand and the tide is coming in.

Unlike virtually every other type of consumer debt, mortgages, car loans, bank loans, even payday loans, the small print on credit cards lets them change interests rates, payment terms, and fees after you borrowed money. By changing the rules in the middle of the game, credit card companies make sure they are the big winners, leaving consumers holding the short end of the stick.

You have heard a lot about universal default. Miss one payment to one creditor and all of your credit cards jack up the interest rate, slash your credit line, and raise your minimum payment.

A couple I spoke with on Monday was doing fine until the husband's employer cut his salary in half. He missed one payment on one credit card, and the interest rate on another one went from 7 percent to 24 percent. His credit line was cut by 80 percent, and his monthly payment tripled. The result: I have a new bankruptcy client. Good for me but bad for his family, the credit card companies, and the economy.

If you think of credit card companies as manufacturers, the cost of their raw material, the money that they lend people who charge things, normally is the Federal funds rate, which is near zero. They take this nearly free money and loan it out at 7 percent if you have good credit, 18 percent if you don't, and 30 percent or more if you miss a payment. Credit card companies are entitled to a fair return, not the excessive earnings from these high interest rates.

But this isn't enough. Fees generate huge profits for credit card companies. They represent 39 percent of revenue, up from 28 percent in 2000. Make a payment after the due date, pay a fee. Go above your credit limit even if the fee is what pushes you over, pay another fee. And how about those annual membership fees, cash advance fees, convenience check fees, balance transfer fees, additional card fees, payment fees, telephone inquiry fees, et cetera? One credit card company even charged a fee if you wanted to cancel your account. The result: Industry profits rose from $27.4 billion in 2003 to $40.7 billion in 2007.

We know from research and experience that there is a strong link between bankruptcy and credit card debt. By the time most of my clients see me about filing for bankruptcy, they have already paid back all the money they originally charged, an equal amount in interest and fees, and they are working hard to try to pay down the third and fourth multiplier of their original purchase.

I met with a client yesterday who stopped using her credit card 3 years ago, has been making payments religiously since, and now owes more than she did when she started. This situation is far from unique, and I see it almost every day in my practice.

We are encouraged that key Committees in both the House and the Senate considered legislation this week to stop the worst of these abusive practices and urge Congress to pass a bill and send it to the President for his signature.

NACBA also supports S. 257, the Consumer Credit Fairness Act. Abusive credit card terms have always been unfair, but in a time of economic crisis when consumers can least afford it, these practices can devastate financially vulnerable families. Congress should take steps to stop these abuses.

Thank you.

[The prepared statement of Mr. Weiss follows:]

PREPARED STATEMENT OF BRETT WEISS

STATEMENT OF BRETT WEISS
Attorney
Greenbelt, MD

On behalf of the National Association of Consumer Bankruptcy Attorneys

before the

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
Judiciary Committee
U.S. House of Representatives

"Consumer Debt: Are Credit Cards Bankrupting Americans?"

April 2, 2009

Chairman Cohen, Ranking Member Franks and Members of the Subcommittee, my name is Brett Weiss and I am a bankruptcy attorney in Greenbelt, Maryland. I appear before you today on behalf of the National Association of Consumer Bankruptcy Attorneys (NACBA).[1] I appreciate the opportunity to offer our comments on how it is that abusive and unfair credit card practices contribute to the growing number of personal bankruptcies in the United States. My testimony is based on over 25 years experience representing consumers in financial distress. It also is informed by the collective experiences of colleagues across the country who represent a broad range of families and households affected by current credit card practices.

INTRODUCTION

Credit cards have become a fixture of U.S. economic life. They provide a tremendous convenience for many consumers who increasingly use credit cards to pay for a range of products and services. For consumers who use a credit card simply for convenience and pay off the balance in full each month, the cards generally work well. The main problems occur when a consumer cannot pay off the full amount due, carries forward a balance, and gets caught in a downward spiral of exorbitant interest rates, fees and penalties, and other billing practices that simply wring more fees out of consumers, driving them further into debt.

There is a strong tendency to believe that individuals or families with credit card debt simply are living beyond their means, making purchases they cannot afford. While societal pressures to consume -- to acquire certain goods and to achieve a certain lifestyle -- have their place in a discussion of credit card debt, the experience of bankruptcy attorneys is that the vast majority of consumers use credit cards as a safety net, to make essential purchases that they are unable to pay in full on a cash basis. Living paycheck to paycheck, these consumers often lack savings to cover unexpected expenses. In a recent survey of indebted low- and middle-income households, seven out of 10 households of all ages reported using their credit cards in this way, relying on cards to pay for car repairs, basic living expenses, medical expenses or house repairs.[2]

It is my experience that few consumers borrow money on credit cards without intending to pay it back. The Federal Reserve Board acknowledges this in its report requested by Congress after enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) which concludes: "Very few households borrow money without intending to repay it; generally it is only after adverse events with serious financial implications that borrowers tend to miss payments and, eventually, seek bankruptcy protection." [3]

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[1] The National Association of Consumer Bankruptcy Attorneys (http://www.nacba.org) is the only national organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. Formed in 1992, NACBA now has more than 3,700 members located in all 50 states and Puerto Rico.

[2] Center for Responsible Lending and DEMOS, "The Plastic Safety Net: The Reality Behind Debt in America," (October 2005), available at http://www.responsiblelending.org/pdfs/DEMOS-101205.pdf.

[3] Board of Governors of the Federal Reserve System, "Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and Their Effects on Consumer Debt and Insolvency," June 2006, p. 16, accessed at http://www.federalreserve.gov/boarddocs/rptcongress/bankruptcy/bankruptcybill study200606.pdf.

These plans to repay, however, easily change, often due to unforeseen, adverse events such as an illness or job layoff. Other consumers fall into traps set by credit card companies and are not always aware or do not understand how it is that penalties, fees and escalating interest rates can quickly transform manageable debt into unaffordable debt.

CREDIT CARD PRACTICES TRAP CONSUMERS IN DEBT

Deregulation of the credit card marketplace, in which state laws limiting interest rates and fees were nullified by two Supreme Court decisions in 1978 and 1996,[4] has drastically changed the way issuers market and price credit cards to consumers of all ages. It is clear that in recent years credit card companies have become far more aggressive in their fees and interest rate practices. The result is that penalty interest rates, high and accumulating fees and interest on fees can push consumers over the financial edge. In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges as in principal. For the growing numbers of consumers who are unable to make more than the required minimum monthly payments on their cards, industry practices often push them into unmanageable credit card debt.

It is the customer who sometimes misses a payment, or sends a payment late or simply pays the minimum due each month who generates the real profits for credit card companies. In 2005, interest and penalty fee revenues alone added up to a staggering $79 billion. By some estimates, nearly eight out of every 10 dollars of revenue for the credit card companies comes from customers who cannot pay off their bills in full every month.[5]

In a more rational market, lenders would limit their risk by restricting the credit available to consumers with riskier credit records or histories, rather than increasing the risk by imposing higher charges on consumers who may be in significant financial distress. But that is what credit card companies appear to be doing; consumers who get in trouble are allowed to continue borrowing, but at higher and higher interest rates and with more and more fees imposed on the account.

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[4] Credit card deregulation began in 1978, with the Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.* (Marquette Nat'l Bank of Minn. v. First of Omaha Serv. Corp., 439 U.S. 299, 99 S. Ct. 540, 58 L. Ed. 2d 534 1978). This case gave national banks the green light to take the most favored lender status from their home state across state lines, and preempt the law of the borrower's home state. As a result, national banks and other depositories established their headquarters in states that eliminated or raised their usury limits. In 1996, the U.S. Supreme Court paved the way for banks that issue credit cards to increase their income stream even more dramatically. In *Smiley v. Citibank (South Dakota), N.A.*, the court approved a definition of interest that included a number of credit card charges, such as late payment, over limit, cash advance, returned check, annual, and membership fees. As a result, national banks and other depositories can charge fees in any amount to their customers as long as their home state laws permit the fees.

[5] Elizabeth Warren, testimony before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, "Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers," January 25, 2007.

Specific Practices That Harm Consumers

Certainly, credit cards provide a great convenience for many consumers. The danger comes from the borrowing features of credit cards, the exorbitant costs of borrowing, and the downward spiral that hits consumers once they get into trouble. Specific practices that harm consumers include:

- Deceptive Marketing
- Aggressive Solicitation and Lack of Real Underwriting
- High Cost Credit
- Punitive Fees
- Penalty Rates and Universal Default
- Changes to Credit Limits
- Debt Collection Abuses
- Use of Mandatory Arbitration Clauses, and
- Change-in-Terms provisions.

Credit card companies push consumers into borrowing because they derive profits mainly from consumers that use their cards to borrow and not from convenience users who pay off their cards in full each month. As discussed above, income loss and increased expenses lead to shortfalls that many consumers attempt to make up by using credit cards. To make matters worse, credit card companies aggressively sell the borrowing features of the cards and push convenience users into borrowing. Companies do this by increasing credit limits, encouraging cash advances at high rates or to increase spending to get rewards and by sending blank checks. All of this is done with little attention to whether the consumer can actually afford to borrow at the rates associated with the borrowing.

While many of these practices alone or in combination can lead to financial trouble for consumers, the focus of this testimony is be on the punitive practices of card companies imposed on consumers when they are struggling to repay their debts and avoid bankruptcy. Rather than assist borrowers who honestly seek to pay off their debts, card companies often prefer to extract as much as they can from borrowers in interest and fees, even though this may make bankruptcy unavoidable.

Punitive Fees and Interest Rates

A significant contributor to snowballing credit card debt is the enormous increase in both the number and amount of non-periodic interest fees charged by card issuers. These punitive fees are imposed on cash advances, balance transfers, wire transfers, late payments and charges that exceed the card's spending limit. Credit card issuers have made these fees higher in amount, impose them more quickly, and assess them more often than previously was the case. Credit card companies now impose these fees not as a way to deter undesirable consumer behavior -- which used to be the primary justification for imposing high penalties -- but as a significant source of revenue. The average late payment fee has soared from $14 in 1996 to over $32 today. Average over-limit fees have similarly jumped from $14 in 1996 to over $30 today.

A penalty rate is an increase in the card's initial annual interest rate (APR) triggered by the occurrence of a specific event, such as the consumer's making a late payment or exceeding the credit limit. Penalty interest rates today can be as high as 30 percent to 40 percent. The new terms apply to the old balance, leaving consumers stuck to pay often significant balances at interest rates far higher than was originally agreed, often with devastating consequences. This practice is especially outrageous when applied retroactively.

So-called "universal default" policies are even more abusive. Under universal default, credit card issuers impose penalty rates on consumers not for late payments or any behavior with respect to the consumer's account with that particular issuer, but for late payments to any of the consumer's other creditors. In some cases, issuers will impose penalties simply if the card holder's credit score drops below a certain number, whether or not the drop was due to a late payment or another factor.

Creditor Practices Push Consumers Into Default

There are volumes of examples of consumers who play by the rules and try to pay their debts, but are driven hopelessly into default by their credit card company. Rather than work with consumers to reduce their debt by curbing excess fees and interest, card companies prefer to get as much out of consumers for as long as possible until they eventually stop paying or file bankruptcy. This was best described in a March 2005 speech by Julie Williams, chief counsel of the Comptroller of the Currency: "Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset."

As a bankruptcy attorney, one of the most frequent complaints I hear is that "I pay and pay and pay every month and my debt doesn't go down much" because of high interest rates and a slew of penalty fees. Consider the case of June Black, age 71, whose financial problems began when she put charges for a doctor visit, medical tests and prescription drugs on her credit card because she couldn't pay the full balance of about $300. Three years later, after a series of fees and finance charges were imposed, Black was more than $6,000 in debt. The Riverside, CA, woman sold her car, moved to a smaller and cheaper apartment and writes a $127 check each month to pay off a credit card she long ago cut up. With the 32.24 percent interest rate she is being charged, Ms. Black has little hope of ever climbing out of the debt. "It just keeps spiraling," Black said of her debt. "I figure I'm going to die before this gets taken care of."[6]

Not long ago the Senate Permanent Subcommittee on Investigations heard testimony of an Ohio resident who exceeded his credit card's $3,000 spending limit by $200 and triggered what wound up as $7,500 in penalties and interest. After paying an average of $1,000 a year for six years and making no additional purchases, the consumer still owed $4,400.

A bankruptcy case from Virginia tells another story of the impact of credit card fees and penalties on the ability of consumers to pay back that debt. During the two year period before she filed bankruptcy, a consumer made only $218.16 in new charges on her Providian Visa. After making $3,058 in payments, all of which went to pay finance charges (at the rate of 29.99%), late charges, over-limit fees, bad check fees, and phone payment fees, the balance on her account

[6] As reported by David Olson. The Press-Enterprise, "More Seniors Struggle with Debt," June 4, 2007.

increased from $4,888 to $5,357. On her Providian Mastercard for the same period, she made only $203.06 in purchases while making $2,008 in payments. Again, all of her payments went to pay finance and other charges, and her account balance increased from $2,020.90 to $2,607.66.

In yet another case, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it filed in several chapter 13 bankruptcy cases.[7] In its findings in support of the Order, the bankruptcy judge listed claims filed in 18 separate cases broken down between principal and interest and fees. On average, interest and fees consisted of more than half (57 percent) of the total amounts listed in the claims. In one case, the card company filed a claim in the amount of $943.58, of which $199.63 was listed as principal and $743.95 was listed as interest and fees. In another case, a claim of $1,011.97 consisted of $273.33 in principal and $738.64 in interest and fees. It is almost certain that pre-bankruptcy payments in these cases had more than paid off the actual purchases made by the consumer.

I could go on and on with examples from own practice and those of my colleagues from around the country of how consumers are pushed into a default position due in large measure to abusive and unfair billing practices by credit card issuers. I will not do that, because I believe the point has been made.

PROPOSALS FOR CHANGE

There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. For example, research by Professor Ronald Mann of Columbia University has found that an increase in credit card spending in the United States and four other countries has resulted in higher credit card debt, which is strongly associated with an increase in bankruptcy filings.[8] To make matters worse, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices in recent years. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.

It is clear that in the midst of the serious economic recession we find ourselves in, that Congress should act to rein in these abusive practices. Although credit card lenders have recently cut back on the amount of new credit they offer and started reducing credit lines for some borrowers, years of aggressive and irresponsible lending have helped put borrowers in a very vulnerable financial position. The "tricks and traps" always have been unfair, but now, at a time of economic crisis when consumers can least afford it, they produce devastating financial repercussions. Moderate income families with little flexibility in their budgets, or those who have experienced a serious loss in income, are particularly hard hit if they have to pay more in unjustifiable fees and credit card interest.

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[7] *In re* Blair, No. 02-1140 (Bankrate. W.D.N.C. filed Feb. 10, 2004).

[8] Mann, Ronald J., "Credit Cards, Consumer Credit and Bankruptcy," Law and Economics Research Paper No. 44, The University of Texas School of Law, March 2006.

We are pleased that key committees in the House and Senate this week are considering measures to rein in some of the most egregious credit card billing practices. Likewise, rules issued by the Federal Reserve late last year and due to go into effect next year, also will go a long way toward curbing some of the most abusive practices.

NACBA also supports S. 257, the "Consumer Credit Fairness Act," introduced in the Senate by Senator Sheldon Whitehouse and colleagues. S. 257 would require that claims filed on "high cost consumer credit transactions," as defined in the bill, are subordinated to all other claims in a bankruptcy case, the bill would give the credit card industry an incentive to keep interest and costs below the definitional trigger. The legislation also provides that the means test under section 707(b) of the Bankruptcy Code would not apply if a consumer's bankruptcy filing resulted from a high cost consumer credit transaction. NACBA supports this provision as it would help some consumers avoid potential litigation costs in proving that a bankruptcy filing was not abusive.

Mr. COHEN. Thank you, Mr. Weiss. I appreciate it.

Mr. Mierzwinski. I have known Ed for some time. He is a consumer advocate and often testifies for Congress and State legislatures and with me at one time in Nashville on a panel I think on the Freedom Center; was it?

Mr. MIERZWINSKI. Right.

Mr. COHEN. He is the U.S. PIRG Consumer Program Director, consumer advocate with the National Association of State Public Interest Research Groups since 1989. He has co-authored numerous reports on consumer issues, ranging from the failure of cable television deregulation to privacy, identity theft, bank fees, predatory lending, and unfair practices, and product safety. He is often quoted in the national press and has appeared on network TV, NBC, Crossfire, ABC, et cetera.

Mr. Mierzwinski is active in international consumer protection efforts and is a founding member of the Trans Atlantic Consumer Dialogue.

We appreciate your being here, and would you please go forward with your testimony?

TESTIMONY OF EDMUND MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP

Mr. MIERZWINSKI. Thank you, Chairman Cohen, Mr. Franks, Chairman Conyers, Members of the Committee. It is a privilege to come here and talk to you about this important issue, and I am glad the Committee is holding this hearing.

The credit card industry business model essentially is a license to steal. As has been pointed out by Mr. Delahunt and others, you can change the rules at any time for any reason, including no reason. You can change the rules even though you have got a 40-page contract. And credit card companies have ratcheted down the thumb screws on consumers since passage of the bankruptcy bill.

As you pointed out, I started at U.S. PIRG in 1989. Just before I came to Washington, Congress passed the Truth in Lending amendment that resulted in the Schumer box, and that is legislation on credit card disclosure. After that bill passed, until the Maloney Credit Cardholders' Bill of Rights passed the House last Congress, no bill opposed by the credit card industry even moved out of the Committee, was even voted on in a Banking Committee of the Congress from 1989 until 2008. At the same time, there was no legitimate regulation of the credit card industry. The OCC, the Office of the Comptroller of the Currency, as the industry consolidated and the biggest companies took over most of the business—eight companies now control well over 80 percent of the credit card industry—the OCC has taken a lax attitude toward regulation. I am not—if I were a credit card company I would not be afraid of these million dollar penalties that are written into the banking laws. The OCC has not imposed a penalty on a big credit card company since the year 2000 and has never imposed a public penalty on Citibank, Chase, or Bank of America. So the credit card companies can do what they will. The OCC has preempted State Attorney General enforcement. And there is one other clause in credit card contracts, and that is the clause that says you are forced to go to

mandatory arbitration even if you do have a problem. So they have taken away private enforcement.

So again the credit card industry is a very powerful industry. The profits of the credit card industry have been very substantial. They are larger than the profits for any other line of banking, and that is according to Federal Reserve reports, not according to consumer group reports.

The issue of whether or not changing credit card company rules would affect credit available to lower income and moderate income Americans is one that we disagree with. We believe that the credit card industry does not make its decisions based on risk. In fact, it makes its decisions based on profits and the ability to extract large profits over time from its customers, as Professor Levitin pointed out, and we concur in our testimony, with Professor Mann's sweat box model. People are paying money to the credit card industry for a very long time that prevents them from ever getting out of the sweat box. The company makes money even if you don't pay off the principal.

So it is a very serious problem that was exacerbated by passage of the bankruptcy amendments of 2005, which keep people in the sweat box longer, which make it harder and more expensive to file for bankruptcy, and make it virtually impossible for many consumers to achieve a chapter 7 fresh start. They are forced into chapter 13 repayment. And in many cases they have to pay off the credit card unsecured debt as well. They don't ever get their feet back underneath them.

So the written testimony that I provided goes into extensive detail on the issues.

I would point out that everybody thought that after passage of the bankruptcy bill, Mr. Chairman, that the industry would change its ways. They got what they wanted, that they would stop making things unfair to consumers. But, in fact, they increased pressure on consumers: Universal default clauses where they not only changed the rules for no reason but they changed the rules based on market conditions or anything that they want.

So there are some real problems with credit cards. There are a number of things that the Committee could do or that the Congress could do. And the fact that the Federal Reserve Board has even proposed and will eventually in July, 2010, make credit card practices illegal shows you that there is a real problem out there. It isn't just consumer advocates saying that some of these practices are unfair; it is the Federal Reserve Board.

And in my testimony I outline some of the things that could be done. Obviously, the Maloney bill, the Credit Cardholders' Bill of Rights, is a better version of the Federal Reserve rules. You should pass in this Committee the Arbitration Fairness Act proposed by Mr. Johnson and we believe is a critical part of reform. On the bankruptcy bill itself, there are a number of changes that we recommend to make it easier for consumers to file for bankruptcy and get out of the sweat box, and we should impose a usury sealing of 36 percent on consumer loans as we did for military families.

And although it is not in my written testimony, I would like to recognize that Mr. Delahunt has recently introduced a very important piece of legislation to provide consumers with a single regu-

lator that imposes—that regulates all consumer credit products. Just as we have a CPSC so your toaster doesn't explode, we would have a Financial Products Safety Commission to protect you against unfair credit card practices.

So these are some of the proposals that we think the Congress should go forward with.

[The prepared statement of Mr. Mierzwinski follows:]

PREPARED STATEMENT OF EDMUND MIERZWINSKI

Testimony Of

Edmund Mierzwinski,
Consumer Program Director,
U.S. Public Interest Research Group

Before The
Subcommittee on Commercial and Administrative Law
of the United States House of Representatives
The Committee on the Judiciary
The Honorable Steve Cohen, Chair

At A Hearing Regarding The Question:

Are Credit Cards Bankrupting Americans?

2 April 2009

Testimony of Edmund Mierzwinski of U.S. PIRG

Chairman Cohen, Ranking Member Franks and members of the Subcommittee, I am Edmund Mierzwinski, Consumer Program Director and Senior Fellow of the non-profit, non-partisan U.S. Public Interest Research Group (U.S. PIRG).[1] We are pleased to offer our testimony today regarding credit card practices and consumer bankruptcy, specifically, on the question: "Are Credit Cards Bankrupting Americans?"

SUMMARY

Your hearing comes at an opportune time. Over the last several years, even after enactment of the draconian 2005 bankruptcy amendments[2] insisted upon by an eight-year credit card industry campaign, the credit card companies have continued to engage in arbitrary, abusive, and unfair credit card lending practices that trap consumers in a cycle of costly debt, such as sharply escalating "universal default" interest rates that can double some cardholders monthly payments overnight. Put simply, owning a credit company is a license to steal. You can change the rules at any time for any reason, including no reason. Pernicious mandatory arbitration clauses prevent consumers from private enforcement against unfair practices. State attorneys general have been preempted by federal regulators from enforcing laws against national banks and thrifts—nearly every large credit card company is a national bank. Those federal regulators, until a recent burst of consumer protection activity by the Federal Reserve, have encouraged the increasing use of unfair practices through lax oversight. Since 2000, the Office of the Comptroller of the Currency (OCC), chief regulator of national banks, has not imposed one public civil penalty or other sanction against a large credit card company.

Considerable evidence links the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. The problem has been exacerbated by the 2005 bankruptcy amendments, which have made it harder and more expensive to file for bankruptcy, leaving many consumers in the credit card company "sweat box," despite no evidence that consumers are abusing the bankruptcy system. Consumers are hurt by credit card practices, but no longer have adequate relief. Congress should immediately reform credit card company practices and make changes to the bankruptcy code to provide relief to aggrieved consumers.

RECOMMENDATIONS TO THE COMMITTEE

Congress should take immediate action to restrict unfair credit card tricks and traps and increase enforcement of credit card laws. Congress should reform the bankruptcy laws so that the victims of these tricks and traps are not prevented from obtaining relief.

1. Congress should immediately enact the strongest possible credit card reforms. S. 414, the Credit CARD Act (Dodd), was approved Tuesday by the Senate Banking Committee. HR 627, the Credit Cardholders' Bill of Rights (Maloney), which passed the House in 2008, was

[1] The **U.S. Public Interest Research Group** serves as the federation of and federal advocacy office for the state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of their members. Main website is uspirg.org. Special credit card reform site is truthaboutcredit.org.
[2] Bankruptcy Abuse Prevention and Consumer Protection Act Of 2005, Public Law 109-8.

considered in a House Financial Services subcommittee yesterday. Both bills are more comprehensive than the proposed Federal Reserve rules.

   a. Final reform should ban a variety of unfair tricks, including universal default clauses, where consumers in good standing are dinged with penalty interest rates for alleged late payments to others, or for no reason at all.
   b. Final reform should ban "any time, any reason" changes to credit card contracts.
   c. Final reform should prevent credit card companies from treating student consumers as special class, by issuing credit cards without regard for ability to repay.

2. Congress should enact the Arbitration Fairness Act, HR 1020 (Johnson), to eliminate mandatory arbitration clauses in credit card (and other consumer) contracts. Congress should take additional steps to reform consumer private rights of action against wrongdoers.
3. Congress should reinstate the rights of state legislatures to enact stronger laws against unfair practices of national banks and reinstate the rights of state attorneys general to enforce laws against national banks.[3] Congress should broaden state attorney general enforcement of federal laws, since federal regulators lack the resources and the will to defend consumers.
4. In 2006, Congress prohibited loans to military families at rates higher than 36% APR. Congress should reinstate usury ceilings for all Americans at the same rate, as proposed in HR 1608 (Speier).
5. Congress should enact a variety of changes to the bankruptcy code to restore its balance and protect Americans from the consequences of these and other unfair practices.
   a. Congress should immediately complete overdue action on the strongest possible version of legislation allowing bankruptcy judges to make loan modifications to prevent foreclosures (HR 200, Conyers). A broad variety of consumer, civil rights, labor and community groups continues to express disappointment to this simple reform to slow the 6,600 foreclosures occurring weekly, which also hurt neighborhoods and the taxpayers paying for the Wall Street bailout.
   b. Congress should take a variety of actions to amend the so-called Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Among the simple actions it could take would be to lower the cost of filing for bankruptcy, subordinate high cost credit transactions to the claims of other claims in bankruptcy, make specific exemptions to means-testing requirements, and repeal pre-bankruptcy counseling requirements.[4]
6. Congress should require that any bank receiving taxpayer-backed infusions of TARP/TALF funds should immediately comply with the credit card rules finalized by the Federal Reserve in December but stayed for compliance until July 2010.

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[3] In 2006, the Supreme Court decision in *Wachovia v. Watters* upheld the bulk of the OCC rules in a statutory interpretation. Before the court for oral argument this term is *Cuomo v. Clearinghouse and OCC*, which may reinstate a narrow portion of attorney general authority—to enforce remaining state consumer protection laws against national banks. The OCC holds that while some fair lending and other laws still apply, it is the only allowable enforcer.

[4] For a detailed analysis of these reforms, see testimony of John Rao, National Consumer Law Center, before the Senate Committee on the Judiciary, 4 December 2008. We concur with Mr. Rao's recommendations in their entirety. Hearing available at http://judiciary.senate.gov/hearings/hearing.cfm?id=3606

DISCUSSION

The Fed's change in regulatory approach is instructive of the worsening situation. The agency, which had relied largely on disclosures as protection, issued its first-ever regulation making certain credit card company practices illegal, using its unfair and deceptive acts and practices authority under Section 5 of the Federal Trade Commission Act.[5] The actions by the Fed, although they will not take effect until July 2010, came none too soon. However, action in both the House and Senate may result in passage of an even stronger law.[6]

Moderate-income families with little flexibility in their budgets are particularly hard hit if they have to pay more in unjustifiable fees and credit card interest. Signs that credit card delinquencies and defaults are rising sharply should be a further warning that these practices have helped make credit card loans unsustainable for many Americans. The meltdown of the subprime mortgage market demonstrates the importance of ending abusive lending practices when warning signs arise. Congress should take steps now to rein in these practices to forestall an even greater economic crisis.

There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. The remainder of this testimony explains how the growth in the use of credit card tricks and traps occurred and its impact on consumers.

A. DID THE BANKRUPTCY LAW FAIL?

Yes, according to U.S. PIRG analysis of research by leading independent academics. "Did the Bankruptcy Law Fail" is the title of a recent article by some of the nation's leading bankruptcy specialists, including Professors Bob Lawless, Katherine Porter and Elizabeth Warren. Here is what they say, including their views on the role played by credit card companies, the leading proponents of that supposed reform enacted in 2005.

> These findings thus cast doubt on the suggestion that those purged from the bankruptcy courts - approximately 800,000 in 2007 alone based on trend extrapolation - were high-income deadbeats; they instead appear to have been ordinary American families in serious financial distress. The data also show that debtors filing for bankruptcy in 2007 have even greater debt loads than their counterparts from 2001, a development that seems to track a national trend of increasing consumer debt. The findings thus align with at least two predictions of some legal scholars. The first is that the bankruptcy reform bill was not aimed at high-income abusers but was instead a general assault on all debtors, regardless of their financial circumstances. **The second is that debtors are waiting longer - and incurring more debt - before ultimately**

[5] Federal Reserve, Office of Thrift Supervision and National Credit Union Administration rules amending Regulation AA and prohibiting certain credit card practices under authority to enforce Section 5 of the FTC Act were issued December 18, 2008 and take full effect in July 2010. The rules apply to all institutions, including those regulated by the OCC. http://www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm

[6] S. 414, the Credit CARD Act (Dodd), was approved Tuesday by the Senate Banking Committee. HR 627, the Credit Cardholders' Bill of Rights (Maloney), which passed the House in 2008, was considered in a House Financial Services subcommittee yesterday. Both bills are more comprehensive than the rules and would take effect earlier.

seeking bankruptcy relief, consistent with the so-called "sweat box" theory of credit card lending [emphasis added]. [7]

These experts go on to explain that since 2005 nothing has really changed in the demographics of people who file for bankruptcy and why they file. Over 90% of filings are still because people get sick, or get divorced or lose their job or a substantial part of their income. Things have just gotten worse for them in the period before they file, if they file:

> The debtors who filed for bankruptcy in 2007 also looked worse than their 2001 counterparts in another respect: they had much more credit card, medical, utility, and other unsecured debt—debt that is either due immediately (utility) or very expensive when financed long-term (credit card).[8]

That sweat box theory is a term coined by another expert, Ronald Mann, who explains it thus:

> In my view, the most important aspect of the new [2005 bankruptcy] law is not the increased payouts associated with means testing, but the way in which the law encourages debtors to defer bankruptcy filings. [...] Another key part of the business model, related to the high switching costs for distressed borrowers, is the increasing ability of the leading issuers to collect substantial revenues in the form of late and over-limit fees. [...] the interest rates that borrowers pay while they are in the sweat box greatly exceed the cost of the lender's funds. Thus, if the borrower resides in the sweat box for very long—making substantial interest payments at a high rate—the lender with a lower cost of funds in effect receives a return of the funds that it has lent each month. If we imagine borrowers who limp along, carrying those balances for decades—neither
> discharging them in bankruptcy, nor ever paying them off entirely, perhaps making an occasional minor purchase—we can see how profitable this business model [the sweat box] can be.[9]

Mann goes on to explain that with these very high interest rates, and low monthly payments at high interest rates and more than occasional penalty fees paid by the consumers in the sweat box, that a consumer account might prove economically profitable after just 30-34 months, but that the affected consumer would have many years more to go to pay off his or her balance. Mann: "this is just about long enough for the lender to recover its investment, but not nearly long enough for the cardholder to repay its debt."[10]

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[7] Quotation is from authors' abstract. Lawless, Robert M., Littwin, Angela K., Porter, Katherine M., Pottow, John, Thorne, Deborah and Warren, Elizabeth, Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors (October 17, 2008). American Bankruptcy Law Journal, Vol. 82, pp. 349-406, 2008; U of Michigan Law & Economics, Olin Working Paper No. 08-023; U of Michigan Public Law Working Paper No. 133; U Illinois Law & Economics Research Paper No. LE08-034; U of Texas Law, Law and Econ Research Paper No. 136; Harvard Law and Economics Discussion Paper; U Iowa Legal Studies Research Paper No. 08-50. Available at SSRN: http://ssrn.com/abstract=1286284

[8] *Ibid.*

[9] Mann, Ronald J., Bankruptcy Reform and The 'Sweat Box' of Credit Card Debt. University of Illinois Law Review, 2006; U of Texas Law, Law and Econ Research Paper No. 75. Available at SSRN: http://ssrn.com/abstract=895408

[10] *Ibid.*

So, it is very clear to bankruptcy experts that the 2005 reforms may have reduced the number of bankruptcy filings, but at a high cost. By making it both harder and more expensive to file for bankruptcy, and then to avoid paying off unsecured debt if you do manage to file, the bankruptcy bill has allowed credit card companies to keep consumers in the "sweat box."

So, to answer the committee's question posited in this hearing, yes, credit cards are bankrupting Americans. While some consumers bearing the brunt of unfair credit card practices may not ever file for bankruptcy, those that do end up filing are worse off than previously because they have been paying more and more credit card penalty fees and penalty interest for a longer period before they file. Of course, once they do go through the new hoops and pay the higher fees required to finally file, they then face the difficulties of the new bankruptcy law itself, which has a tough means test that requires more of them to enter Chapter 13 repayment plans that then require continued payment of those unsecured debts to credit card companies. As Mann points out, the credit card company has probably already found that consumer profitable. It then uses the bankruptcy law to squeeze more from him or her and delay their re-entry into the full economic system.

B. CARDHOLDERS ARE SHOWING SERIOUS SIGNS OF ECONOMIC STRESS

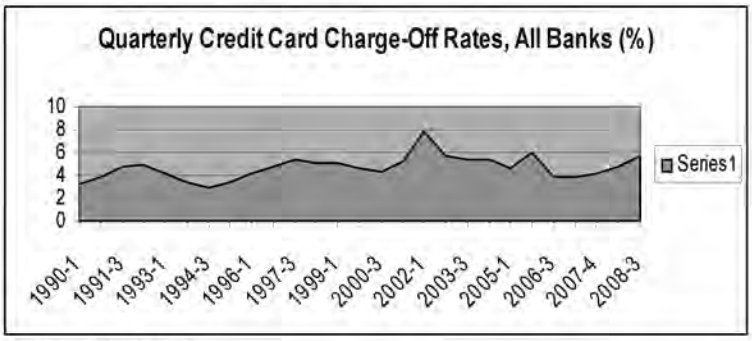
Credit card debt now held by Americans is approaching one trillion dollars,[11] up 20% since 2003.[12] Lower income and minority Americans face a higher burden of debt as a percentage of income than more affluent Americans, placing greater stress on them.[13]

As the economy has worsened and home foreclosures have increased to record levels, consumers are increasingly having serious difficulty paying their credit card bills. One widely watched measure of financial health, the amount of credit card debt paid off by Americans monthly, is now at one of the lowest levels ever recorded.[14] Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or "written off," have been persistently high for most of the last thirteen years and are now approaching the highest levels on record. During the decade between the end of 1995 and the start of 2006, credit card charge-offs were not below 4 percent in a single quarter.[15] They increased to more than 4 percent in the fourth quarter of 2006 and broke 4 percent again during the later half of 2007. Since then, charge-offs have escalated sharply to 5.62 percent in the third quarter of 2008. There is a very good chance that charge-offs will keep rising because the number of delinquent credit card payments – an early sign of payment difficulty – are also approaching historically high levels. Thirty-day credit card

[11] According to Federal Reserve statistical release G-19 for March, revolving debt (nearly all is credit card debt) was $961 billion dollars in January 2009.
[12] Garcia, Jose, "The New Squeeze: How A Perfect Storm of Bad Mortgages and Credit Card Debt Could Paralyze the Recovery," Demos, 2008. Available at http://www.demos.org
[13] Garcia, Jose, :Borrowing To Make Ends Meet," Demos, 2007, available at http://www.demos.org
[14] Chu, Kathy, "November Credit-Card Payoff Rate Fell Sharply," *USA Today*, February 8, 2009. The monthly payment rate fell by 2.5 percentage points to 16.1 percent in November 2008, according to CardTrak.com.
[15] Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks," available at www.federalreserve.gov/release/chargeoff. Most experts attribute lower charge-offs in 2006 to the surge of bankruptcy filings (and corresponding increase in charge-offs) that occurred in the third and fourth quarters of 2005.

delinquencies are now at their highest point in six years, since the last economic recession ended.[16] Moreover, a number of major issuers have reported fourth quarter charge-offs that indicate that borrower defaults and issuer losses will exceed those of the last two recessions.[17] The difficulty that many families are having affording their credit card bills has been exacerbated by the mortgage crisis. As home values have dropped sharply, Americans have been unable to use home equity loans and home refinancing to pay off their credit card debts.[18] Moreover, despite rising credit card delinquencies, there is evidence that some families are attempting to stay current on their credit card loans but not their mortgage payments, a shift in behavior from past economic crises.[19]

Quarterly Credit Card Charge-Off Rates, All Banks (%)[20]



Source: Federal Reserve.

Although some issuers have suffered losses in the last year, over time the credit card industry has been the most profitable in the banking sector, earning a return on assets (ROA) from 1995 to 2008 that was more than three times greater than that for commercial banks overall.[21] Because of the

[16] 30-day credit card delinquencies during first three quarters of 2008 were between 4.79 and 4.88 percent, the highest levels since 2002. Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at 100 Largest Commercial Banks" "U.S. Credit Card Delinquencies at Record Highs – Fitch," *Reuters*, February 4, 2009.

[17] Terris, Harry, "Credit Card Losses Seen Surpassing Levels of Last Two Recessions," *American Banker*, January 28, 2009.

[18] Westrich, Tim and Weller, Christian E., "House of Cards, Consumers Turn to Credit Cards Amid the Mortgage Crisis, Delaying Inevitable Defaults." Center for American Progress, February 2008.

[19] Chu, Kathy, "More Americans Using Credit Cards to Stay Afloat," *USA Today*, February 28, 2008.

[20] Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks." available at www.federalreserve.gov/releases/chargeoff/chgallsa.htm , accessed April 14, 2008.

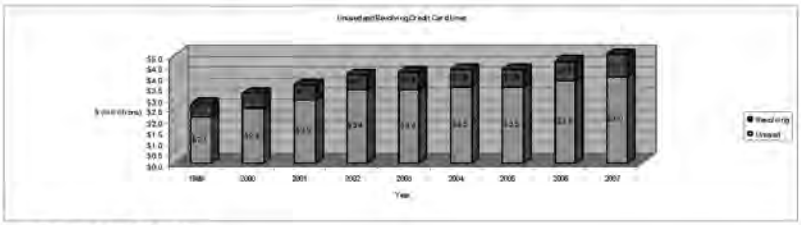
[21] "Card Profits 04," *CardTrak*, January 24, 2005; "Banner Year," *CardTrak*, February 2004; FDIC, *FDIC Quarterly Banking Profile*, Third Quarter 2006 at 5, Table I-A; FDIC, *FDIC Quarterly Banking Profile*, Fourth Quarter 2000 at 4, Table I-A. Commercial banks' average return on assets between 1995 and 2004 was 1.23 percent, less than one third the size of the credit card industry average return on assets of 3.73 percent over the same period, according to R.K. Hammer and Associates.

high mortgage losses that many large banks experienced in 2007, there was more than a five-fold difference between bank and credit card profits.[22]

C. CONSUMERS HAVE SHOWN FAR MORE CAUTION IN TAKING ON CREDIT CARD DEBT THAN ISSUERS USED IN MARKETING AND EXTENDING CREDIT

It is conventional wisdom that consumer demand fueled the growth of revolving debt to about $961 billion.[23] However, a careful analysis of lending patterns by credit card companies shows that aggressive and even reckless lending by issuers played a huge role in pushing credit card debt to record levels. From 1999 through 2007, creditor marketing and credit extension increased about twice as fast as credit card debt taken on by consumers,[24] even though the rate of growth in credit card debt in 2007 was the highest it had been since 2000.[25]

The debt growth rate started slowing in the second quarter of 2008 and then experienced a rare decline in the fourth quarter.[26] This most significant reason for this drop was probably the decline in consumer spending brought on by the recession. Additionally, issuers significantly reduced their marketing of new credit and started reducing some existing credit lines in the latter half of 2008.[27]



Source: VERIBANC, Federal Reserve.

[22] ROA for credit card issuers in 2007 was 4.65%. R.K. Hammer and Associates. January 2008. ROA for commercial banks in 2007 was .86%. FDIC, "Banks and Thrifts Earned $105.5 billion in 2007," February 26, 2008.

[23] As of January 2009, the amount of revolving debt held by Americans was $961billion. Although this figure is often used as a proxy for credit card debt, most experts believe that outstanding credit card debt is slightly lower. First, approximately 5 percent of consumer revolving credit is not on credit cards. Second, between 4 to 9 percent of the debt does not truly revolve. It is repaid to the credit card issuer before the next billing cycle starts. Taking these two factors into account, outstanding credit card debt is likely to be between $829 and $877 billion.

[24] VERIBANC, Inc. (www.VERIBANC.com) and Federal Reserve Consumer Credit Outstanding. According to Federal Reserve figures, consumer revolving debt grew by 50 percent from $627.5 billion in December 1999 to $941.4 billion in December 2007. According to VERIBANC, unused lines of credit grew at almost double the rate (90.5 percent) that consumers increased their use of credit card lines, increasing from $2.1 trillion in 1999 to just under $4.0 trillion ($3,983,200,614) at the end of 2007.

[25] The amount of revolving debt increased by 7.8 percent in 2007, which was the sharpest increase since revolving debt grew by 11.6 percent in 2000. Federal Reserve, Statistical Release, "Consumer Credit Outstanding," Table G.19.

[26] The amount of credit card debt in the fourth quarter of 2008 dropped by 5.4 percent, from $976.7 billion to $963.5 billion. Federal Reserve, Statistical Release, "Consumer Credit Outstanding," Table G.19.

[27] Wolfe, Daniel, "Top Issuers, with Less Appetite for Risk, Slashing Credit Lines, *American Banker*, December 2, 2008. Banjo, Shelly, "Credit Card Companies Slash Credit Limits," *The Wall Street Journal*, January 5, 2009.

A similar trend is evident when examining the consumer response to massive increases in marketing by creditors that started in 1990. The most significant form of marketing for creditors remains solicitation by mail. Over half of credit cards held by consumers are the result of mail solicitation.[28]

Issuers increased the number of mailed credit card offerings six-fold from 1990 to 2005, from just over 1.1 billion to a record 6.06 billion.[29] Since then, solicitations dropped to 5.8 billion in 2006, 5.2 billion in 2007, and 3.8 billion in 2008.[30] Wealthier families receive the highest number of credit card mailings, but low-income families are more likely to open the solicitations they receive.[31] The table at right indicates that issuer interest in marketing credit cards grew much faster than consumer interest in accepting new cards. The consumer response rate to mail solicitations declined seven-fold from 2.1 percent in 1990 to 0.3 percent in 2005, picking up slightly to 0.5 percent in 2006 and 2007. This means that for every 250 solicitations consumers receive, they reject more than 249. The tiny response rate demonstrates that the vast majority of consumers are being responsible when offered unsolicited credit.

	Solicitations (billions)[32]	Response Rate
1990	1.1	2.1%
1991	0.99	2.4%
1992	0.92	2.8%
1993	1.5	2.2%
1994	2.5	1.6%
1995	2.7	1.4%
1996	2.38	1.4%
1997	3.01	1.3%
1998	3.44	1.2%
1999	2.54	1.0%
2000	3.54	0.6%
2001	5.01	0.6%
2002	4.89	0.5%
2003	4.29	0.6%
2004	5.23	0.4%
2005	6.06	0.3%
2006	5.8	0.5%
2007	5.2	0.5%

D. ISSUERS ENCOURAGE THE LEAST SOPHISTICATED AND RISKIEST HOUSEHOLDS TO RUN UP UNSUSTAINABLE LEVELS OF DEBT

The growth of revolving debt in this country to $964 billion has obviously not affected all Americans equally. The extraordinary expansion of the credit card industry in the 1990s was fueled by the marketing of credit cards to populations that had not had widespread access to mainstream credit, including lower- and moderate-income households, consumers with seriously blemished credit histories, college students, older Americans and minorities.

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.[33] According to

[28] Vertis Inc., press release, "Financial Direct Mail Readers Interested in Credit Card Offers," January 25, 2005; "Card Marketing 101," *CardTrack*, September 2002.
[29] Synovate Mail Monitor, press release, "Mail Monitor Reports Record Six Billion Credit Card Offers Mailed in U.S. during 2005," April 27, 2006.
[30] Synovate Mail Monitor, press release, "U.S. Credit Card Mail Volume Declined to 3.8 billion in 2008," January 30, 2009.
[31] Kidane, Amdetsion and Sandip Mukerji, Howard University School of Business, "Characteristics of Consumers Targeted and Neglected by Credit Card Companies," *Financial Services Review*, Vol. 13, No. 3, 2004 at 186.
[32] Synovate Mail Monitor
[33] Cardweb.com

the Federal Reserve Board, about 42 percent of cardholding households pay their credit card bill in full every month,[34] which means that the remaining 50 million or so families that carry debt owe an average of about $17,000.[35]

Moderate and lower income households that are more financially vulnerable shoulder a significantly higher level of debt relative to their incomes. In the current economic climate, these households are also under financial pressure from many external factors, such as flat wages, rising unemployment, skyrocketing home foreclosures and increasingly unaffordable health insurance. In other words, the "democratization of credit" has had serious negative consequences for many Americans, putting them one unexpected financial emergency away from bankruptcy.

Lower-Income and Minority Households

Close to half of all minority families in the U.S. carry credit card debt.[36] Although lower and moderate-income households are less likely to have bank credit cards than more affluent families, they are more likely to carry over debt from month-to-month. Sixty one percent of the lowest income households with a card carry balances, compared to 45 percent of higher income families.[37] Credit card debt also represents a significant portion of lower-income families' income. A 2004 Gallup poll found that families with credit card debt earning under $20,000 a year owed 14.3 percent of their income in credit card debts, those earning between $20,000 and $29,999 owed 13.3 percent and those earning between $30,000 and $39,999 owed 11.0 percent. Compare this to the 2.3 percent of their income owed by families earning over $100,000.[38] The increase in credit card debt has contributed to alarmingly high overall levels of debt for many of these lower and moderate-income families. More than one-quarter of the lowest income families spent over 40 percent of their income on debt repayment in 2001.[39]

[34] Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," Federal Reserve Bulletin, vol. 92, February 2006, pg. 31.
[35] CFA calculation based on estimated credit card (as opposed to revolving) debt of $850 billion. If a conservative estimate of 75 percent of 114.4 million households have credit cards, and only 58 percent of these households carry debt, then the remaining 49.7 million households have an average of $17,103 in debt.
[36] Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 92, February 2006, pg. 24.
[37] Board of Governors of the Federal Reserve System, "Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency," submitted to the Congress pursuant to section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, June 2006 at 9 Table 6.
[38] Gallup Poll News Service, "Average American Owes $2,900 in Credit Card Debt," April 16, 2004.
[39] Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. In 2001, more than one in four (27.0%) families in the lowest income quintile spent more than 40% of their income on debt payments, compared to less than one in six (16.0%) of families in the second lowest income quintile and one in nine (11.0%) of all families who spent 40% or more of their income on debt payments.

Younger and Older Americans

Starting in the early 1990's, credit card issuers targeted massive marketing efforts at college campuses throughout the country, resulting in a sharp growth of credit card debt among college-age and younger Americans. The Consumer Federation of America (CFA)[40] with Dr. Robert Manning, and U.S. PIRG[41] were among the first to document the serious consequences of this trend. Since U.S. PIRG's 1998 Campus Credit Card Trap report and Dr. Manning's report for CFA in 1999, this issue has been the subject of much public and media scrutiny. And yet, Americans under 35 years-of-age continue to show more signs of trouble managing credit card debt than any other age group. The amount of credit card debt held by students graduating from college more than doubled to $3,262 between the mid-1990s and 2004.[42] Americans under 35 are less likely to pay off their credit card balances every month than average Americans,[43] are paying more for debt obligations than in the past and are increasingly likely to pay more than 40 percent of their incomes on credit card debt.[44] Moreover, there is increasing evidence that issuers are now targeting high school students with credit card offers.[45] They are also marketing branded debit cards to adolescents, in part to encourage these young consumers to use similarly branded credit cards when they are older.[46] U.S. PIRG's most recent report also documented intense marketing of credit cards on college campuses and the growing use of contracts between colleges (sometimes through their alumni associations) and credit card companies for exclusive marketing of both credit and debit cards to college students.[47]

The growth of credit card debt among older households is also troubling. Although these households were long thought to be the most frugal and resistant to consumer debt, changing economic conditions – especially declining pension and investment income coupled with rising health care and prescription costs – have made credit card debt a more serious financial issue for older Americans. Between 1992 and 2001, Americans over age 65 saw their credit card debt nearly double from $2,143 to more than $4,000.[48] The number of seniors filing for bankruptcy more than

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[40] Manning, Robert, "Credit Cards on Campus: Costs and Consequences of Student Debt," June 8, 1999. CFA Press Release available at: http://www.consumerfed.org/cestudent.pdf

[41] Mierzwinski, Edmund, "The Campus Credit Card Trap," April 1998, U.S. PIRG Education Fund; Mierzwinski, Edmund and Lindstrom, Christine, "The Campus Credit Card Trap: A Survey of College Students and Credit Card Marketing," March 2008, U.S. PIRG Education Fund; Mierzwinski, Edmund and Lindstrom, Christine, "Characteristics of a Fair Campus Credit Card," U.S. PIRG Education Fund, April 2008. Both of the 2008 reports are available at http://www.truthaboutcredit.org.

[42] Trigaux, Robert, "Generation Broke: New Grads Bear Heavy Load," *St. Petersburg Times*, November 22, 2004.

[43] Draut, Tamara, Director of Demos Economic Opportunity Program, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 8. More than half (55%) of Americans carry revolving balances compared to 71% of borrowers aged 25-34.

[44] *Ibid.* at 4-5. In 1992, about one in thirteen (7.9%) Americans aged 25-34 had debt greater than 40% of their income; by 2001, about one in eight (13.3%) had these high debt burdens.

[45] Mayer, Caroline E., "Girls Go From Hello Kitty To Hello Debit Card; Brand's Power Tapped to Reach Youth," *The Washington Post*, October 3, 2004.

[46] Ludden, Jennifer, "Credit Card Companies Target Kids," *All Things Considered*, National Public Radio, February 6, 2005.

[47] Testimony of Christine Lindstrom, Director U.S. PIRG Higher Education Program, at a hearing on "Problem Credit Card Practices Affecting Students: The Need for Legislative Action," before the Subcommittee on Financial Institutions, June 26, 2008 available at http://financialservices.house.gov/hearing110/hr0626084.shtml.

[48] Demos, "Retiring in the Red," January 19, 2004 at 3.

tripled from 1991 to 2001.[49] More recent data from a 2008 AARP report[50] show that "Americans 55 and older have experienced the sharpest increase in bankruptcy filings."

Seniors have fewer credit cards than other age groups and are more likely to pay their credit cards in full every month, but a greater proportion of older Americans also have lower incomes.[51] This means that credit card debt has a more severe impact on this age group. For example, credit card debt can threaten older homeowners, who stand to lose their home – and their most significant hedge against poverty – if they use home equity to pay off credit card debt.

The Downsizing of Minimum Payments

As credit card issuers dramatically expanded their marketing and extension of credit in the 1990s, they lowered monthly minimum payment amounts. By reducing the minimum payment, issuers could offer more credit, encourage consumers to take on more debt, and ensure that consumers would take far longer to pay off their debts, thus making them more profitable for the industry.[52] Monthly minimum payment rates were reduced from around 5 percent of principal owed in the 1970s to just over 2 percent by the turn of the century.[53] In 2005, 19 million credit card borrowers make only the minimum payments.[54]

The number of consumers paying just above the minimum rate is even larger. In a representative survey conducted for the Consumer Federation of America by Opinion Research Corporation in November of 2005, 34 percent of those questioned said that they usually pay the minimum rate or somewhat more. More than 40 percent of respondents earning less than $50,000 a year said they paid the minimum rate or somewhat more, while 45 percent of African Americans and 51 percent of Hispanics did so.[55] An examination by the Credit Research Center of 310,000 active credit card accounts over 12 consecutive months in 2000 and 2001 found similar results. Just under one-third of the accounts paid 5 percent or less per month of the total amount due.[56] Moreover, payment habits for many cardholders are not static over time. Depending on the economic circumstances of the cardholder involved, he or she could shift from fully paying outstanding balances every month to paying at or near the minimum rate.

However, paying only the minimum on credit cards can increase the length of time the debt is carried and significantly add to the interest cost of the credit card loan. Julie Williams, the First

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[49] Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001, at 5. The number of older Americans declaring bankruptcy during this period rose from 23,890 to 82,207.

[50] Generations of Struggle, Research Report, AARP Research Institute, Deborah Thorne, Ohio University, Elizabeth Warren, Harvard Law School, Teresa A. Sullivan, University of Michigan, June 2008, available at http://www.aarp.org/research/credit-debt/debt/2008_11_debt.html

[51] Hanway, Steve, "Do Credit Card Habits Improve with Age?" Gallup News Organization, May 18, 2004. Nearly half (48%) of households over 65 years old have incomes below $30,000, compared to 16% of those aged 30-49 and 18% of those aged 50-64.

[52] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.

[53] Kim, Jane J., "Minimums Due on Credit Cards are on the Increase," *Wall Street Journal*, March 24, 2005.

[54] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.

[55] Opinion Research Corporation, "Consumer Financial Services Survey," November 3-7, 2005.

[56] Credit Research Center, McDonough School of Business, Georgetown University.

Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency (OCC) has noted that reduced minimum payments "dig borrowers into an ever deeper hole, requiring increasingly more difficult measures" for consumers to get out of debt.[57] CFA has concluded that reduced minimum payments were a significant cause of increasing bankruptcies in the last decade.[58]

One way to alert consumers to the consequences of paying off credit card balances at the minimum rate is to offer each consumer a personalized notice on the billing statement about how long it would take to pay off the balance at the minimum rate, and what would be the total costs in interest and principal.[59] Such a personalized disclosure is, unfortunately, not included in the recent bankruptcy law, which requires consumers to call a toll-free number to get information about how long it would take to pay off their balances.[60] No specific information would be offered on the total cost of paying at the minimum rate. This bankruptcy law requirement will likely have no impact on the millions of consumers paying at or near the minimum rate who will not call a toll-free phone number.

One positive development regarding credit card minimum payments is that regulatory guidance issued by federal banking regulators in January 2003 directed credit card lenders to set minimum payments that "amortize the current balance over a reasonable period of time" and noted that prolonged negative amortization would be subject to bank examiner criticism.[61] Many major credit cards began increasing their minimum payments requirements in 2005, including Bank of America, Citibank, Discover and JP Morgan Chase,[62] in some cases to as high as 4 percent.[63] All issuers were required to fully phase in the changes by the end of 2006.[64]

The Office of the Comptroller of the Currency (OCC) has warned banks that increasing minimum payments may need to be accompanied by a reduction in Annual Percentage Rates (APRs) or eliminating fees to ensure that cardholders can actually reduce their balances and not just tread water with higher minimum bills.[65] Since the increases took effect, consumers with interest rates

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[57] OCC, Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel before the Risk Management Association's Retail Risk Management Conference on Regulatory Concerns about Certain Retail Banking Practices, Chicago, June 3, 2003, in "Speeches and Congressional Testimony," *OCC Quarterly Journal*, Vol. 22, No. 3, September 2003 at 107.

[58] Consumer Federation of America, "Consumer Restraint Pressures Lenders to Reduce Credit Card Marketing and Credit Extension," January 18, 2000.

[59] Proposed in S. 1176 by Senators Akaka, Durbin, Leahy and Schumer.

[60] Public Law 109-8. This weaker provision has been implemented as part of the Regulation Z disclosure rules approved by the Federal Reserve and other regulators on 18 December 2008 but compliance is not required until July 2010.

[61] Joint press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003, see attached "Account Management and Loss Allowance Guidance" at 3.

[62] American Financial Services Association, "Credit Card Minimum Payments Going Up," *Spotlight on Financial Services*, April 2005.

[63] Warnick, Melody, "Credit Card Minimum Payments Doubling," *Bankrate.com*, May 3, 2005. Citibank and Bank of America have announced they are doubling their minimum payment requirements from 2% to 4% of the balance.

[64] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

[65] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.

above 20 percent have had to cope with payments that have roughly doubled.[66] Consumer groups are unaware of banks that have reduced interest rates.

Targeting Consumers on the Brink of Financial Distress

Nothing illustrates the perverse incentives (and dangers) of the credit card market better than the marketing of cards to consumers with tarnished credit histories, or even worse, to those who are literally on their way to or just coming out of bankruptcy. For example, in the first half of 2007, as home mortgage foreclosures shot up and signs of a serious economic slowdown started to appear, some of the nation's largest credit card issuers increased the number of solicitations they mailed to sub-prime consumers by 41 percent compared to the first half of 2006.[67]

Other major issuers and many smaller companies market high-cost, sub-prime cards to those with blemished credit histories. This population of cardholders can be profitable for the industry. Credit card industry consultant Andrew Kahr estimates that average sub-prime consumers will make two or three late payments a year, from which the industry can generate a separate fee, and that these fees can greatly exceed the interest payments on the small lines of credit themselves.[68]

Sub-prime consumers haven't just encountered high-cost offers of credit, but deceptive marketing practices. In 2000, Providian was required to pay more than $300 million in restitution to its sub-prime cardholders for unfair and deceptive practices.[69] Cross Country Bank, the sub-prime and secured credit card issuer that has been investigated by state and federal regulators for misleading consumers about the terms of its sub-prime credit card accounts and engaging in abusive collection practices, has advertised on late-night and daytime television when more unemployed potential sub-prime customers are more likely to be watching television.[70]

In December of 2008, sub-prime card marketer Compucredit reached a settlement with federal regulators to provide at least $114 million in consumer redress and pay a $2.4 million fine for deceptive marketing of high-fee, low-limit credit cards. Among other allegations, Compucredit was accused of marketing cards with a $300 limit, but failing to adequately disclose the $185 in fees that would be immediately charged to the card.[71]

Consumers exiting bankruptcy are often swamped with offers at prime terms – low interest rates and without annual fees.[72] Many bankruptcy attorneys believe these offers are being made because consumers leaving bankruptcy court cannot erase their debts for another six years. Under the new bankruptcy legislation consumers will not be able to wipe away any credit card debts for eight

[66] "Minimum Payments," *CardTrack*, September 6, 2006.
[67] Gavin, Robert, "Credit Card Companies Pursue Subprime Borrowers," *Boston Globe*, September 5, 2007.
[68] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.
[69] OCC, Statement of Comptroller of the Currency John D. Hawke J., June 28, 2000.
[70] Paelle, Mitchell, "Pushing Plastic," *Wall Street Journal*, November 5, 2004.
[71] "Subprime Credit Card Marketer to Provide At Least $114 Million in Consumer Redress to Settle FTC Charges of Deceptive Conduct," Federal Trade Commission, Dec. 19, 2008, http://www.ftc.gov/opa/2008/12/compucredit.shtm.
[72] Mayer, Caroline E., "Bankrupt and Swamped with Credit Offers," *Washington Post*, April 15, 2005.

years. Some categories of credit card debt will not be "dischargeable" at all, no matter how long the consumer waits.[73]

E. ISSUERS HAVE PURSUED ABUSIVE INTEREST RATE, FEE AND RISK MANAGEMENT POLICIES THAT HAVE A HARMFUL IMPACT ON MANY HOUSEHOLDS, AFFECTING BANKRUPTCY RATES

There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. For example, research by the previously referenced Professor Ronald Mann of Columbia University has found that an increase in credit card spending in the U.S. and four other countries has resulted in higher credit card debt, which is strongly associated with an increase in bankruptcy filings.[74] To make matters worse, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices in recent years. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.[75] In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges, as in principal.

High fees and interest rates can often result in negative amortization, where the principal owed on credit card debt continues to rise despite making payments. Negative amortization in effect traps credit card borrowers on a debt treadmill that keeps moving faster. Although they are making regular payments, their debts continue to mount. In 2004, a Cleveland judge ruled against Discover Card's efforts to collect debts from a cardholder whose balance nearly tripled from $1,900 to $5,564 without making additional purchases because of fees and penalties, including $1,158 in over-limit fees alone. The judge ruled that Discover's practices were unconscionable under state law.[76]

In another case, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it files in chapter 13 bankruptcy cases.[77] In its findings in support of the Order, the bankruptcy judge listed claims filed in eighteen separate cases broken down between principal and interest and fees. On average, interest and fees consisted of more than half (57 percent) of the total amounts listed in the claims. In one case, the card company filed a claim in the amount of $943.58, of which $199.63 was listed as principal and $743.95 was listed as interest and fees. In another case, a claim of $1,011.97 consisted of $273.33 in principal and $738.64 in interest and fees. It is almost certain that pre-bankruptcy payments in these cases had more than paid off the real charges made by the consumers.[78]

While the 2005 changes may have reduced overall filings, at least in the short run, the changes have not reduced unfair practices by credit card companies.

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[73] *Ibid.*
[74] Mann, Ronald J., "Credit Cards, Consumer Credit and Bankruptcy," Law and Economics Research Paper No. 44, The University of Texas School of Law, March 2006.
[75] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.
[76] National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.
[77] *In re* Blair, No. 02-1140 (Bankrate. W.D.N.C. filed Feb. 10, 2004)
[78] National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.

Penalty Fees

Traditionally, penalty fees were designed to deter irresponsible cardholder behavior, but in recent years these fees have become primarily a revenue enhancer for credit card issuers. An analysis by the United States Government Accountability Office (GAO) found that, "...typical cards today now include higher and more complex fees than they did in the past for making late payments, exceeding credit limits, and processing returned payments."[79] The GAO also identified several new fees that issuers have begun using in recent years, some of which they are not required to disclose to consumers in advance. One example of such a fee is the so-called "pay-to-pay" fee for the payment of bills by telephone, which can range from 5 to 15 dollars.[80]

A substantial number of Americans are paying these fees. Thirty-five percent of the credit card accounts from the six largest issuers that the GAO examined had at least one late fee in 2005,[81] representing about 242 million credit cards.[82] Thirteen percent of all accounts – or about 90 million cards – were assessed over-limit fees in 2005.

Late fees have been steadily rising over the past decade and can easily exceed monthly payments for consumers paying low minimum balances.[83] In 1996, a Supreme Court decision prohibited states from setting limits on the fees credit card companies could charge their cardholders. Prior to this court ruling, credit card late fees were commonly around five to ten dollars, but have risen sharply since the decision.[84] The GAO analysis found that late fees jumped sharply after the court ruling. The GAO examined fee data collected by CardWeb.com and found that late fees jumped by 160 percent from $12.83 in 1995 to $33.64 in 2005. The GAO also found a sharp fee increase from data collected by Consumer Action, which showed a 119 percent increase from $12.53 in 1995 to $27.46 in 2005.[85] Even more striking, the GAO found that late fees paid by borrowers with typical balances were an average of $37 in 2005.[86] This is important to note as credit card issuers are increasingly assessing "tiered" fees based on the borrower's balance.

[79] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.
[80] *Ibid*, p. 23.
[81] *Ibid*, p. 1.
[82] CFA calculation based on 691 million credit cards. *Ibid*, p. 9.
[83] "The Ugly Issuer," *Credit Card Management*, September 2004.
[84] Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.
[85] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.
[86] *Ibid*, p. 20.

Credit card issuers used to reject transactions that exceeded a cardholder's credit limit, but it has become common for issuers to accept the transaction and then apply an over-limit fee on cardholders who exceed their credit limits.[87] These fees are often applied by issuers in addition to a higher "penalty" interest rate charge for exceeding the credit limit or carrying a high balance.[88] These monthly fees are charged every month a consumer carries a credit balance higher than their credit limit. According to the GAO report, data collected by Consumer Action shows a 114 percent increase in over-limit fees between 1995 and 2005.[89] Critics of this practice argue that issuers should not assess a penalty fee when they can simply enforce the credit limit if they wish to prevent consumers from exceeding it.

Penalty Interest Rates Are Imposed On Top Of Penalty Fees: The Double Ding

Payment of a late fee no longer serves as a form of liquidated damages. The vast majority of credit card issuers also impose a double ding: they increase interest rates for credit card account holders who pay their bills late, even by a few hours. In 2005, Consumer Action found that 78.7 percent of issuers charged penalty rates for late payments on their cards.[90] For example, representatives for one large issuer told the GAO that they automatically increase a customer's interest rate if this person pays late or exceeds the credit limit. The GAO found that all but one of the 28 cards from the six largest issuers they reviewed charged default rates in 2005. By 2008, 94% of new credit card solicitations included a penalty rate.[91] The average default rate in 2008 is 28.6 percent, up from 23.7 percent in 2003.[92] Even more striking, the spread between the penalty rate and the standard purchase rate more than doubled between 2000 (8.1%) and 2008 (16.9%).[93]

Some consumers with low-rate cards could have their interest rates double overnight for being late on one payment to their credit card.[94] Some issuers also say that they will charge default interest rates for exceeding the credit limit on the card or for returned payments, or that they will increase interest rates for cash advances and balance transfers for violations of card terms.[95]

There is increasing evidence that those who can least afford these higher interest rates – financially vulnerable families – are most likely to be paying them. A study by the research organization Demos found that cardholders that carry debt who earn less than $50,000 a year are more than twice

[87] "The Ugly Issuer," *Credit Card Management*, September 2004.
[88] Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.
[89] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 20.
[90] Consumer Action, 2005 Credit Card Survey, "Card Companies Use Common 'Risk Factors' to Impose Unfair Rate Hikes, Finds CA," *Consumer Action News*, Summer 2005.
[91] Frank, Joshua M., *Priceless or Just Expensive? The Use of Penalty Rates in the Credit Card Industry*, p. 10, Center for Responsible Lending (December 16, 2008), hereafter Frank, *Priceless or Just Expensive*., available at http://www.responsiblelending.org/pdfs/priceless-or-just-expensive.pdf.
[92] Id at 9. (The 2006 GAO report did find that some issuers do not assess default rates unless there are multiple violations of card terms. "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, pgs. 24, 25.)
[93] Frank, *Priceless or Just Expensive*, at 9-10.
[94] Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.
[95] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 25.

as likely to pay interest rates above 20 percent as the highest income Americans who carry debt. African-American and Latino credit card holders with balances are more likely than whites to pay interest rates higher than 20 percent.[96]

One recent study estimated that the cost of the penalty rate shock cost a revolver carrying the average $10,678 balance $1800 a year.[97] At a time when we are looking for ways to put money back in the hands of families, reducing this $150 a month surtax could have a real stimulative effect.

Retroactive Application of Penalty Rates

All issuers also apply penalty interest rates retroactively to prior purchases. This has the effect of increasing the price on purchases already made but not paid off.[98] Some cards even apply penalty rates to debts that were already paid at a lower rate.[99] There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance. There is no other industry in the country that is allowed to increase the price of a product once it is purchased. Issuers have already assessed a consumer's risk of not repaying the loan and presumably offered an interest rate based on that risk. Issuers should be required to allow a consumer to pay off his or her existing balance at that interest rate.

Even for consumers who clearly are becoming higher risk, such as those who are a full thirty days late in paying a credit card bill, it is harmful to cardholders and, ultimately, lenders to impose a retroactive rate increase on the existing balance. These families are struggling and need help getting out of debt; they should not be shoved deeper underground. Retroactive penalty interest rate hikes for these cardholders only increases the likelihood that they will completely default, which is in no one's interest. The primary effect of a punitive retroactive rate increase appears to be to escalate the proportion of the consumer's debt owed to the card issuer and to put the card issuer at an advantage over the consumer's other creditors. This practice is unfair to creditors who do not escalate the debt owed by families having difficulty making ends meet.

Universal Default

Universal default clauses in credit card contracts allow credit card companies to raise interest rates on debtors who have problems with other creditors or whose credit scores decline. The increases are triggered not just by a late mortgage or credit card payment to other lenders but also to payment disputes with other types of creditors, like utilities or book clubs.[100] A review of credit card disclosures issued in October 2006 by Consumer Action found five major issuers that said they reserved the right to assess universal default interest rates. Since that time, Citigroup and JP Morgan Chase have said that they will not use the practice, although Citigroup changed this policy

[96] Wheary, Jennifer, and Tamara Draut, "Who Pays? The Winners and Losers of Credit Card Deregulation," Demos, August 1, 2007.
[97] Frank, *Priceless or Just Expensive*, at 1.
[98] Draut, Tamara, Director of the Economic Opportunity Program at Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 16-17.
[99] McGeehan, Patrick, "The Plastic Trap," *New York Times*, November 21, 2004. Discover disclosed to its customers that it had changed the terms of its interest rates from a low of zero to 19.99% for a single late payment, but it applied that rate increase for late payments from 11 months prior to the disclosure of the changing interest rate terms.
[100] Burt, Bill, "Pay One Bill Late, Get Punished by Many," *Bankrate.com*, January 20, 2004.

in the fall of 2008.[101] On the other hand, representatives for Bank of America and Discover testified before the Senate late last year that they still use consumer credit scores, at least in part, to trigger higher default interest rates.[102]

It is fundamentally unfair to impose a penalty interest rate on a consumer who has not made a late payment or defaulted on an obligation, especially when this rate increase is applied retroactively. Another concern with using credit reports to trigger a penalty rate is the problems with inaccuracies in credit scoring and credit reporting that CFA and other organizations have documented.[103] Moreover, issuers who impose sharp interest rate increases on consumers who are meeting their obligations often fail to provide any rationale – much less a legitimate one -- for the increase. In January, Bank of America began increasing interest rates on some cardholders to as high as 28 percent but did not inform consumers the reason for the increase in the notification they mailed.[104]

Although credit card issuers contend that interest rate penalties that increase because of universal default are related to the credit risk of the borrower, the application by some issuers of these punitive rate hikes seems to belie that contention. One late payment can result in significant increases in interest rates in some cases, even though there is little evidence that a single late payment to one creditor increases the likelihood of default to all creditors. Moreover, increased fee and interest rate payments may have a similar or greater impact on the borrower's ability to repay than modest problems with another creditor.

Indiscriminate, Undisclosed Changes in Rates and Fees

Many credit card companies reserve the right to change the terms of their credit card contract at any time and for any, *or no*, reason. This allows credit card companies to arbitrarily raise interest rates even for cardholders in good standing and with perfect credit histories. Media reports of recent rate hikes by Bank of America demonstrate the unfairness of any-time/any-reason changes: some consumers saw their interest rates triple without explanation.[105] The result of these unfair clauses is that consumers can't depend on the interest rate promised to them.

In the last few months, JP Morgan Chase has begun charging approximately 400,000 cardholders a $10 a month fee. It is also increasing the minimum payment amount for these consumers from 2 to 5 percent, a substantial amount. Many of these cardholders appear to have been promised a fixed interest rate for the life of the balance.[106]

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[101] Dash, Eric, "Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult' Environment," *New York Times*, November 15, 2008.
[102] Credit Card Practices: Unfair Interest Rate Increases, U.S. Senate Permanent Subcommittee on Investigation, December 4, 2007.
[103] Consumer Federation of America and National Credit Reporting Association, "Credit Score Accuracy and Implications for Consumers." December 17, 2002. CFA and NCRA reviewed over 500,000 credit files and found that 29 percent of consumers have credit scores that differ by at least 50 points between the credit bureaus.
[104] "A Credit Card You Want to Toss," *Business Week*, February 7, 2008.
[105] Ibid.
[106] Chu, Kathy, "Chase Adds Fee for Low-Rate Credit Cards," *USA Today*, February 9, 2009.

Pricing Tricks: Double Cycle Billing and Manipulation of Payment Allocation

The GAO found that two of six major creditors are using a practice called double-cycle billing, which results in illegitimate interest charges on balances that have already been paid on time.[107] Since then, one of these issuers, JP Morgan Chase, has announced that it will no longer use double-cycle billing. With this practice, issuers consider two billing cycles in assessing interest. A consumer who begins with no balance and pays off most but not all of the purchases he or she makes in the first month would still be charged interest for the entire amount of the balance in the second month. A fair billing process would only result in an interest charge on the amount of the unpaid balance.

The GAO also determined that for 23 of the 28 large issuer cards they reviewed, cardholder payments were first allocated to the balance assessed at a lower rate of interest.[108] The actual proportion of large issuers who in effect use this policy is likely closer to 100 percent since the remaining five issuers applied payments "subject to their discretion". This practice is problematic for the many cardholders who now carry balances at different rates of interest, such as introductory "teaser" rates, cash advance rates, and balance transfer rates. The lower interest rate balances must first be paid off before the issuer will allocate payments to higher rate balances. Allocating payments to lower interest rate balances first unfairly extends the length of time it takes consumers to pay down their balances while increasing the finance charges that issuers earn. Furthermore, a recent study has shown this payment allocation policy and its impact to be very poorly understood by consumers.[109] The study also showed this issuer policy causes pricing to be less related to risk, the opposite of what issuers claim they wish to achieve.

Increases in Credit Card Fees and Interest Rates Significantly Affect Consumer Debt

Penalty fees and interest made up more than three-quarters of credit card issuers revenues throughout 2002 and 2003. Credit card issuers earned $65.4 billion in interest and $7.7 billion in penalty fees in 2003 or 75.7 percent of the total $96.5 billion in revenue.[110] In 2002, penalty fees and interest made up 76.8 percent of the industry's $97.1 billion in revenues. For the approximately 88 million credit cardholding households, penalty fees and interest on their credit card debt cost an average of $830 in 2003.[111]

Unsavory Credit Limit Practices

In its 2008 survey of credit card terms and conditions, Consumer Action identified some unsavory credit limit practices used by major credit card issuers. While reducing credit availability can be a responsible way for credit card issuers to manage growing financial risk during difficult economic times, these aggressive credit line policies can harm consumers.

[107] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 27.
[108] *Ibid.*
[109] Frank, Joshua M., *What's Draining Your Wallet? The Real Cost of Credit Card Cash Advances*, Center for Responsible Lending (December 16, 2008), available at http://www.responsiblelending.org/pdfs/whats-draining-your-wallet.pdf.
[110] Daly, James J., "Smooth Sailing," *Credit Card Management*, May 2004 at 31.
[111] Consumer Federation of America calculation from Daly, James J. 2004 and Census Bureau figures.

Each in its own way puts consumers at greater risk of being charged higher interest rates, falling deeper in debt, and causing a ripple effect among issuers. Consumers reported some credit limit practices to Consumer Action that are patently unfair.

- Following you down. As consumers pay off large balances, the credit limit is reduced so that the balance is always close to the credit limit.
- Sorry, you're over limit. Credit limits are reduced to levels lower than the current balance, triggering over limit fees and requiring a large "balloon" payment of the over-due amount. This practice also puts the consumer at risk of being hit with a penalty interest rate.
- Where's my credit limit? Cards are declined at the point of purchase, and only then do cardholders find out that their limits have been reduced with no warning.
- Ganging up on consumers. One credit card issuer lowers your credit limit, which lowers your credit score, which causes another of your cards to lower your credit limit.

The Combined Effect of Abusive Practices during the Recession

Although credit card issuers have curbed aggressive marketing and cut back on credit extension in the last year, they appear to be accelerating the use of many of the irresponsible and harmful practices detailed above to cut or mitigate their losses. For example, card issuers have used their ability to unilaterally change the terms of credit card contracts by raising interest rates even as the Federal Reserve has sharply reduced the federal funds rate.[112] They have also added new fees,[113] increased the amount of fees,[114] and, as detailed above, used harmful rather than responsible methods to lower credit lines. Citigroup back-peddled last fall on its promises not to increase interest rates "at any time for any reason."[115] As mentioned above, Chase has suddenly started charging hundreds of thousands of cardholders fees of $120 a year, while sharply increasing the monthly amount that these cardholders owe each month. Bank of America and Capital One have used vague clauses in cardholder agreements to raise interest rates on cardholders because of "market conditions."[116] Issuers have every right to try and limit their losses during the current economic crisis if they act responsibly, but the use of these harmful, unjustified and sometimes arbitrary practices is contributing to the economic insecurity of millions of families who thought they were complying with their obligations.

[112] Trejos, Nancy, "Less Power to Purchase, Consumers' Credit Card Limits Slashed as Companies Try to Reduce Risk," *Washington Post*, November 16, 2008.
[113] Lieber, Ron, "Credit Card Companies Go to War Against Losses," *New York Times*, January 31, 2008.
[114] Trejos, Nancy, "Less Power to Purchase, Consumers' Credit Card Limits Slashed as Companies Try to Reduce Risk," *Washington Post*, November 16, 2008.
[115] Dash, Eric, "Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult' Environment," *New York Times*, November 15, 2008.
[116] "Card Rates Rise 'Out of the Blue,'" *The Oregonian*, January 25, 2008. Kimes, Mina, "Card Companies Jacking Up Rates," *Cable News Network*, http://money.cnn.com/2008/09/26/news/economy/creditcards_kimes.fortune/.

When "Risk-Based" Pricing is Predatory

Credit card issuers often claim that their interest rate and fee policies are justifiable because they are necessary to compensate for the increased financial risk of lending to borrowers with blemished or limited credit histories. It is true that borrowers who pay their balance every month are receiving a valuable service at no cost in many cases. It is quite possible, in fact, that riskier borrowers who revolve their debt and pay higher interest rates and fees are subsidizing in-part the cost of services that these non-revolvers receive. It is important to note, though, that issuers still receive substantial fee income from merchant "interchange" fees and, in some cases, from annual fees.

The key question is whether interest rates and fees charged to riskier consumers are fair and can be legitimately related to the actual financial risk incurred by creditors. There is increasing evidence that the answer to this question is "no."[117] It is becoming more apparent that many of the most abusive fees and interest rates are assessed simply because it is what the market will bear.

The amount of fees and penalty interest rates do not appear to be proportional to the risk or cost incurred by issuers. For many years, issuers have justified "sticky" interest rates that rise faster than they decline by stating that these higher interest rates were necessary to compensate for increased risk. As issuers have increased the number and amount of fees and penalty interest rates they charge, it seems that higher baseline interest rates alone are not sufficient anymore to compensate for risk. There is very little evidence that relatively modest problems, like one or two late payments of a short duration – significantly increase a consumer's chances of default. It would appear to be impossible to justify charging a consumer with a reasonably good credit history with a late payment fee of $35 and a default interest rate of 29 percent on prior purchases, in addition to the finance charge the consumer would already pay on a fairly high interest rate, such as 17 percent. One sign that default rates may not be truly reflective of costs or risk incurred by issuers is that the "fixed amount" that issuers add to the index rate in setting default rates rises when the cost of funds declines. The GAO found that this fixed amount increased from about 19 percent in 2003 to 22 percent in 2005 on the 28 large issuer cards they evaluated.[118]

In response to these "tell-tale" signs of price gouging, it is time for issuers to provide more information to lawmakers and to the public about their real costs to demonstrate that their pricing practices are truly fair.

F. FEDERAL RULE ON UNFAIR AND DECEPTIVE CREDIT CARD PRACTICES

On December 18, 2008, the Federal Reserve Board, the Office of Thrift Supervision and the National Credit Union Administration issued a final rule to curb unfair and deceptive practices by credit card issuers. The rules do not take effect until July 1, 2010.[119]

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[117] Testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center, before the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee of the United States House of Representatives, March 13, 2008.

[118] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 24.

[119] Federal Reserve System, 12 CFR Part 227 [Regulation AA; Docket No. R-1314]; Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 535 [Docket ID. OTS-2008-0027] RIN 1550-AC17; National Credit Union

The new rules prohibits or restricts a number of abusive practices, including:

- **Interest rate increases on existing balances, unless the cardholder is more than 30 days delinquent.** The rule does not prohibit prospective "universal default" rate increases because of a supposed problem that the cardholder has with another creditor. It does eliminate the practice as applied retroactively, which has provided a major financial incentive for issuers to use it, though consumers struggling with their debt, who have missed a payment, could still be hit with large retroactive rate increases. The rule prohibits issuers from increasing interest rates on existing balances because a cardholder has made a minor mistake, such as paying late by a few days.

- **Payment allocation methods that cause debts to escalate**. The rule takes steps to require credit card issuers to more fairly apply the payments that cardholders make to balances with different interest rates. When consumers transfer balances with low, short-term "teaser" rates (that have higher rates for new purchases), or take out high-rate cash advances, issuers will be required to apply payments either to the higher rate debt or to both the higher and lower rate debt proportionately. Currently, credit card issuers apply payments only to the lower rate debt. Though the rule improves current payment allocation practices significantly, consumers would still be unable to completely pay off costly high rate balances by making extra payments unless the consumer pays off the lower rate balances at the same time.

- **Interest charges on debts that have already been paid**. The rule forbids "double cycle billing," which results in cardholders paying interest on debts paid off the previous month during the grace period.

- **Excessive fees for low-credit cards**. The rule forbids credit card companies that target consumers with poor credit histories from requiring consumers to pay fees that amount to more than half of the credit being offered, if those fees are charged to the card that is being issued. If the fees being charged to the card amount to more than one-quarter of the credit line, cardholders will be allowed to pay these fees off over a six-month period.

The rule is an important first step in stopping issuers from using some unfair and deceptive practices to increase the amount of debt consumers owe. However, it is not helpful to consumers struggling to pay off hefty debts in the middle of a recession to allow issuers to continue to use for another year and a half practices that federal regulators have deemed to be abusive. The Credit Cardholders' Bill of Rights Act under consideration the Financial Services Committee achieves both of these goals. (See below for discussion of this bill and how it compares to the regulators' rule.)

Administration, 12 CFR Part 706, RIN 3133-AD47; Unfair or Deceptive Acts or Practices. http://www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm

G. ENSURING THAT CREDIT CARD ISSUERS RECEIVING GOVERNMENT ASSISTANCE OFFER LOANS THAT ARE FAIR AND SUSTAINABLE

As part of the federal government's efforts to rescue the financial sector, credit card banks are receiving taxpayer assistance in several forms, including through the direct infusion of funds and the Troubled Assets Relief Program (TARP). On February 10th, Treasury Secretary Geithner announced that he would expand an additional program designed to make consumer credit more widely available. The Term Asset Backed Securities Loan Facility (TALF) would use the Federal Reserve Board's credit facility power, be operated by the Federal Reserve Bank of New York, and include a special purpose vehicle capitalized from TARP funds. Initially, the program was to use $20 billion to support a program for up to $200 billion in non-recourse loans to buyers of securities backed by non-mortgage debt, including consumer credit card debt. In other words, buyers of credit card securitizations would be able to borrow funds from the Federal Reserve Bank of New York to purchase these securitizations, with repayment from revenues from the securitized credit card debts. Secretary Geithner said he wants to expand the program to support between $500 billion and $1 trillion in lending.

A diverse coalition of more than twenty organizations led by Consumers Union has called on Secretary Geithner to require that any securitized debt whose purchase is financed through this program meet standards for fairness and truthfulness, including those standards were finalized in December 2008 by the Federal Reserve Board.[120] The groups sought this change to ensure that any consumer credit card debt facilitated through this taxpayer-backed program will promote, rather than damage, household economic stability.

Specifically, the organizations called on Secretary Geithner to impose two minimal eligibility conditions on all financing by the TALF for credit card securitization pools:

1. Immediate compliance with details of the rule against unfair or deceptive acts or practices for all consumer credit card debt in the pool; and

2. A specific program for cardholders to earn a reduction in penalty interest rates back to a lower standard rate after no more than six months of on-time payments for all consumer credit card debt in the pool.

Any government backed program to make capital available for credit card debt must be limited to that credit card debt which is not associated with practices that federal regulators have determined to be unfair or deceptive. Federal backing of credit card securitizations must also be limited to credit card debt with a clear "road map" to non-penalty rates for households who pay on time while under a penalty rate.

A stated purpose for the Troubled Assets Relief Program (TARP) is to restore stability to the financial system. However, the first installment of TARP money did not even begin to promote financial stability for borrowers, homeowners, and communities in the face of the tide of foreclosures, onerous credit card practices, and the crying need for affordable, sustainable,

[120] https://mail.consumerfed.org/exchweb/bin/redir.asp?URL=http://www.consumersunion.org/pdf/TALF.pdf.

systematic loan modifications. The new TALF program for non-mortgage debt should limit its offer of liquidity to avoid the type of credit card debt that detracts from sustainable lending and household financial stability.

Providing more capital for credit card lending will not meet the national need for enhanced financial stability for households if the credit card debt that is facilitated under the TALF can continue until July 1, 2010 to contain the harmful terms and practices that the Federal Reserve Board and two other federal regulators have identified as unfair or deceptive. The challenges for the U.S. economy are great. Consumers cannot be the engine of economic recovery if they are burdened with high interest rate credit card debt that federal regulators have determined is not justified. Any further taxpayer assistance to credit card issuers must include conditions that will ensure that the credit provided will promote, or at least not be detrimental to, family economic stability.

H. H.R. 627—Credit Cardholders Bill of Rights

The "Credit Cardholders' Bill of Rights Act" (Maloney) helps restore fairness to the credit card marketplace. (Note: The bill was considered yesterday in a House Financial Services subcommittee so it may been have changed,)

The bill would require credit card issuers to take a number of steps to treat consumers more fairly, including:

1. **Ending Bait and Switch Contract Clauses.** H.R. 627 invokes the basic tenet of fair dealing by prohibiting credit card companies from changing contract rules in the middle of the game through "any time, any reason" interest rate and fee hikes. Instead, they must disclose, up front, the specific, material reasons for which they will unilaterally change contract terms.

2. **Limiting Retroactive Application of Rate Hikes for Consumers in Good Standing.** H.R. 627 prohibits card issuers from applying "universal default" interest rate hikes retroactively to balances borrowed at a lower rate. As cited above, some issuers still use credit information not related to the account a consumer has with that company, such as a drop in a consumer's credit score, to raise interest rates. While consumers with a perfect payment history with their credit card company are understandably outraged when their interest rate rises for these reasons, the devastating consequences of retroactive application of these increases is equally egregious. Minimum monthly payments rise, sometimes dramatically. The time to pay-off the balance increases, sometimes by many years, while the total cost of the debt skyrockets. H.R. 627 limits these destabilizing impacts by prohibiting the retroactive application of rate hikes not related to the cardholder's credit card account.

3. **Preventing Credit Card Companies from Gaming Consumer Payments.** H.R. 627 reduces the ability of card companies to play costly games with consumer payments by requiring them to apply payments proportionately to card balances with different interest rates. As stated above, when consumers accept card offers for short-term teaser rates for balance transfers and cash advances and higher rates for other balances, credit card companies apply payments *first* to the lower-rate balance, preventing consumers from

paying off higher interest balances and imposing unwarranted and costly finance charges. Issuers refuse to apply *any* portion of a consumer's payment to the higher interest rate balance, preventing consumers from paying down *any* portion of the high-cost balance until the lower interest rate balance is repaid. As a result, balances build up at the much costlier rate and finance charges accrue.

4. **Prohibiting Unfair and Hidden Interest Rate Charges on Balances Repaid During the Grace Period.** H.R. 627 prohibits credit card companies from using "double-cycle billing" to charge interest on balances repaid during the grace period. As mentioned above, this practice allows credit card issuers to sap unwarranted finance charges from the wallets of consumers who usually do not carry balances. Although some credit card issuers have disavowed this practice, some still engage in it. This legislation makes clear that a grace period is a grace period.

5. **Ending Unfair Late Fees for On-Time Payments**. H.R. 627 ends the classic late-fee gotcha. Consumers who mail their payments well in advance are often socked with a late fee of up to $40 because of card companies' own processing delays or arbitrary deadlines. The abuse has been exacerbated as credit card companies have shortened the time period in which consumers can make an on-time payment. Other consumers make electronic payments on the due-date, only to be hit with a late fee because they posted their payment five minutes after the issuer's arbitrary deadline on that day. The legislation provides that consumers demonstrating that they have paid their bill at least seven days before the due date are presumed to have paid on time and cannot be charged a late fee. It also sets a single uniform time of no earlier than 5 p.m. local time by which payments must be received on the due date to prevent companies from setting earlier and arbitrary deadlines that result in late fees. Issuers must also mail credit card bills 25 days before the bill is due, instead of the current rule requiring only 14 days, to help ensure that consumers will have enough time to pay.

These provisions largely track those required in the credit card rule finalized by federal regulators. There are a few significant differences, however. Most important is that H.R. 627 will take effect three months after enactment, while the regulators' rule does not take effect until July of 2010. Protections that are in H.R. 627 that are not included in the regulators' rule include:

- Consumers will be able to choose not to be allowed to exceed their credit limit
- Credit card companies will not be able to extend credit to borrowers younger than 18.
- Consumers who receive extraordinarily high-cost "subprime" cards would be better protected under H.R. 627. The Board rule permits fees to consume 50 percent of the consumer's credit line, whereas under H.R. 627 fees cannot be charged to more than 25 percent of the credit line.

Protections that are included in the regulators' rule that are not in H.R. 627 include:

- Prohibiting the practice of deferring interest rate payments. Deferred interest usually involves an advertised promise such as "no interest for one year," but the fine print calls for

interest to be charged retroactively if the consumer does not fulfill a condition of the deferral agreement, such as paying in full before the end of the deferral period.

- Banning the hair-trigger loss of promotional interest rates. Issuers would not be able to use any reason they wanted to raise a promotional rate during the promotional period, but could only do so of a cardholder was thirty days or more late in paying a bill.
- Prohibiting "universal default" rate increases on future purchases for the year a card is issued. The rule primarily restricts interest rate increases on existing balances, but in this case the rule would prohibit interest rate increases prospectively for the first year a card is issued, because of a supposed problem the cardholder has with another creditor or a drop in the cardholder's credit score.

We recommend that the Congress conform H.R. 627 to the additional requirements in the rule. We also recommend that the Congress include in H.R. 627 several additional provisions that would enhance consumer protection not yet addressed by the bill, including: a ban on all universal default rate hikes, including prospective rate hikes before the card expires; a prohibition on retroactive application of *any* rate hike to prior balances; a requirement that the size of penalties charged by issuers be directly related to actual costs incurred; and a requirement that credit card issuers ensure that young consumers have the ability to repay the loans they are offered.

We also recommend that the Congress eliminate a provision in H.R. 627 allowing issuers to charge over-limit fees for three consecutive months, even if the cardholder only exceeds the credit limit with a single transaction. Instead, H.R. 627 should prohibit issuers from charging over-limit fees if they choose to allow a cardholder to exceed the credit limit.

Taken together, the reforms offered in H.R. 627 would be an important first step in making the credit card marketplace fairer and more transparent. By prohibiting issuers from using questionable methods to sharply increase some "back end" interest charges, this bill would start to shift pricing in the industry to the "front end," especially the initial interest rate. It would encourage issuers to compete to attract consumers based on those initial charges, and to use responsible risk-management techniques to manage their financial exposure if the risk profile of the borrower declines over time. The bill would not stop issuers from using responsible risk-based pricing methods to establish initial interest rates or to change them prospectively if the borrower's credit worthiness declines.

Conclusion

We appreciate the opportunity to provide our views to the Subcommittee today. We hope our testimony has illustrated that at the intersection of many consumer problems in today's world you can find both credit card company practices and the bankruptcy changes of 2005 demanded by those firms. Both need reform. We look forward to working with you on changes to laws that will better protect American families from unnecessary economic stress brought on by harsh credit card practices and unwarranted restricted access to a bankruptcy fresh start.

Mr. COHEN. Thank you, sir.

We have completed our testimony. We have one vote. Mr. Delahunt is going to be our scout and get there and let them know we are coming. Thank you. Kit Carson. Then we are going to resume downstairs in 2141, our normal hearing room. Mr. John and Mr. Weiss, will you be able to rejoin us? It shouldn't be more than 20 or 30 minutes at the most.

Thank you very much. We are in recess.

[Recess.]

Mr. COHEN. Mr. Franks, thank you. We are back in session. I thank you for coming back on this opportunity for questioning.

First, I would like to ask Mr. John, and I had a little trouble hearing in the other room, you were saying something about time, and about having to reset computers or something. Was that about the date that the regulations go into effect?

Mr. JOHN. It was, yes.

Mr. COHEN. The regulations go into effect I think in—is it July of 2010?

Mr. JOHN. It was an 18-month delay from the December 2008 issuing.

Mr. COHEN. Do the banks use the first computers ever made? Are these something like the Flintstones computers?

Mr. JOHN. Well, not to my knowledge, actually. The computers are highly complex. And one of the——

Mr. COHEN. Temperamental.

Mr. JOHN. Well, all computers I think by definition are temperamental, at least mine is. But the thing is that this is an incredibly complex network. And the regulations are very extensive and will require severe changes to the way the industry does business. And as a result, it is not just a matter of redoing computers, it is a matter of retraining staff, it is a matter of reprinting disclosure forms and a variety of other things.

Mr. COHEN. Let me ask you this, following up on what Mr. Delahunt had for us; when they can change for any reason, and they do often change the cutoff dates, the due dates, et cetera, do they take 18 months before they implement those things?

Mr. JOHN. Well, I seriously doubt it. But when it comes down to it, that is a fairly simple change as far as dates and interest rates. This is a much more extensive change that has to go through the entire system.

Mr. DELAHUNT. Would the Chair yield?

Mr. COHEN. I would yield to the distinguished vice Chairman.

Mr. DELAHUNT. With the new rules that have been promulgated, would one of those rules eliminate the I-can-do-whatever-I-want-whenever-I-want-it provision?

Mr. JOHN. Pretty much.

Mr. DELAHUNT. It would. Okay. I would like to see a copy of that. I thank the gentleman.

Mr. MIERZWINSKI. Could I add to that response?

Mr. DELAHUNT. Please.

Mr. MIERZWINSKI. It is our understanding that it would do it retroactively on your existing balances. The Federal rules, however, would not affect future use of your card. So if they raised your rate and they said your new rate is 39 percent APR because you did

something bad, it wouldn't apply to your retroactive balance, but it would apply to your future use of your card in many circumstances.

Mr. JOHN. But may I point out that even under existing law, a consumer who gets a change and decides that they don't want to accept that can simply stop using the card and pay off the balances under the existing contract.

Mr. COHEN. Mr. Levitin.

Mr. LEVITIN. That is true, but this is not like an antidrug campaign, it is not so easy to just say no if you are a cardholder. Applying for a new card takes some time, that it affects your credit if you close one card line and open another, that affects your credit score. So that is going to mean that, even if you have done nothing wrong, the cost of credit in the future will go up. So this is not costless.

Professor Larry Ausubel at the University of Maryland has a study that estimates that, given the point at which consumers actually will switch, they have to incur something like $150 worth of additional interest costs before they will switch cards. That is a pretty hefty amount of interest there.

Mr. COHEN. When you say it is not like drug use, do you think—and I know you are not a psychologist, but aren't some people kind of addicted to purchasing and shopping and consumerism?

Mr. LEVITIN. It is like drug use in this sense; there is definitely an addictive quality to credit. I am not in any position qualified to say whether it is psychologically addictive or somehow chemically addictive. I can't say that. But there definitely are parallels between the way consumers use credit and what we see with addictive products.

And to that extent, there is also another analogy that works. The relationship between the cardholder and the card issuer is a little bit like addict and pusher. It is a codependent relationship, and you do need to have both. Consumers don't just spend freely, they need an issuer who is willing to extend them credit.

And when we have consumers who get into problems with credit, often if you look at bankruptcy filers, they don't just have one card where they spent this $10,000, they will have 20 cards and multiple cards from the same bank and with $5,000, $10,000 on each of these cards. And you have to ask yourself, the last bank in the door, what were they thinking extending more credit to this consumer? A consumer who is earning 70,000 or $40,000 a year and they have already a $100,000 in credit card debt, what is the lender thinking? Where do they think this is going to end up?

Mr. COHEN. Well, it may be, Mr. Levitin, that they have got these old computers. I bought my home in 1988, and the late Sally Glass and the late El Sigurber lived in my home before their demise in 1980. In 1996, they got several credit card opportunities because of their good credit rating. Now, it is true that in the 16 years since their death they had not had a bad debt, but it was also kind of amazing that they should get such a solicitation. And I used to get enumerables.

Mr. DELAHUNT. Would the Chair yield for a moment?

Mr. COHEN. Yes.

Mr. DELAHUNT. And I don't mean to distract you, but I live here in Washington with three other gentlemen, Members of the House and the Senate, and I found interesting that there was a solicitation that was sent to that same residence for a gentleman by the name of Wilbur Mills. Now, I think that maybe Mr. Conyers actually would have served with him in his youth.

Mr. CONYERS. He got me on Judiciary.

Mr. DELAHUNT. He got you on Judiciary. That is good to know. But Mr. Mills had been dead at the time as well. There is something faulty with these computers. And I think this Committee ought to examine the need to update the computers that are used in our financial services systems because it is becoming very problematic.

Mr. COHEN. Does any one of the panelists agree with my basic theory, that 18 months waiting to implement these regulations is beyond what is necessary for computer—I have got to think Bill Gates could have done quicker than this.

Mr. MIERZWINSKI. Mr. Chairman, I think all of the consumer groups that are working on this legislation agree with your perception that 18 months is too long. They changed the rules on us in 1 day. We have asked, as Representative Speier in a markup yesterday said, we asked General Motors and the other car companies to change their entire business models in 60 days, why did the credit card companies need 18 months?

We are very pleased that the Federal Reserve identified practices that it decided should be made illegal under the Federal Trade Commission Unfair and Deceptive Practices Act authority that the Fed has. But to wait 18 months to stop the illegal activity is astonishing, and it is just notacceptable. And we don't think it is needed for computers or any other reason.

Mr. COHEN. Thank you. I am going to yield to Chairman Conyers or to Mr. Delahunt, whoever wants to go next.

Mr. CONYERS. This is just an informal discussion here between us late in the afternoon, last day before we go into recess.

Mr. John, in 2005, did you happen to testify in the bankruptcy revision proceedings?

Mr. JOHN. I did not.

Mr. CONYERS. You didn't. Did you write anything on the—I see you have done numerous work in public relations and media.

Mr. JOHN. Not to my knowledge. I actually was involved, when I was with the National Association of Federal Credit Unions, in an earlier revision of the bankruptcy bill, which would have been in the early nineties. And I was involved strictly peripherally when I was with Representative Sanford's office.

Mr. CONYERS. Okay. Now you heard the introductory statements of Chairman Cohen. Did he say anything that, in your lengthy experience, struck you as something that you would like to put any finishing touches or modifications on?

Mr. JOHN. I would never assume that I can improve on a Chairman's opening statement.

Mr. CONYERS. Not even Chairman Cohen.

Mr. JOHN. Very definitely not, especially not as long as he is sitting there.

Let's just say that there would probably be certain aspects of it that I would be in more agreement on than others.

Mr. CONYERS. Now, what about Chairman Delahunt's ranting and raving, Vice Chairman Delahunt, certainly you saw some openings for further discussion in that regard, didn't you?

Mr. JOHN. Oh, I am sure there are many openings for discussion. But having worked on the Hill for many years, I would be hesitant to challenge a vice Chairman, also.

Mr. CONYERS. What about just an ordinary Member of the Committee like myself? I mean, what about some of the things that we said that you—look, we can't have all four of you coming here and sitting here telling us that everything is okay with everything we said. Reticence is not becoming to witnesses; we need you to come in here and lay it out, good, bad or indifferent.

Mr. JOHN. My personal opinion would be that you have identified some very serious problems. I would also suggest that the Federal Reserve, whether you like the 18 months or not, has actually done some very extensive work in trying to deal with those problems, and in particular with redesigning the statements in ways that will be very useful for consumers.

Now, nothing is going to be perfect, but when it comes right down to it, further legislation—and legislation did pass the Senate Banking Committee by one vote yesterday on this subject—is not necessarily going to be the best approach to dealing with these problems for the simple reason that you are going to be up against—you are going to be explicitly banning or attempting to ban certain practices, and you are going to have some exceedingly high-paid attorneys and financial professionals who are going to be on the other side trying to find a loophole to get around it. And to the extent these are put into legislation, as opposed to leaving them to the regulators to deal with, with some very clear instructions, you are going to find basically that you are always going to be running to catch up. And I don't necessarily think that is going to be your major goal.

Plus, as I said, one of my key concerns—because I do a fair amount of work in the whole issue of asset building in lower and middle-income families—is the fact that there is no costless reform to this, and I am very concerned that the very people who most need to start building themselves up the credit ladder are going to be the ones who find themselves shut out as a result.

Mr. CONYERS. As a result of what?

Mr. JOHN. As a result of practices that will sharply reduce the profitability of credit cards, sharply reduce the circumstances under which they are issued, et cetera. We are already seeing changes in credit standards, credit standards being sharply strengthened now due to perceived risk and other things. This is especially hitting the lower and middle-income community. The last thing we need to do is to set something up that has the completely unintentional result of making it harder for these people to find credit and, therefore, forcing them into the hands of even more check cashing agencies, or something along that line.

Mr. CONYERS. Could I get a little more time, Mr. Chairman, to pursue this, please?

Mr. COHEN. Sure.

Mr. CONYERS. Thank you very much.

How can correcting the existing practices that have pushed people to the brink of bankruptcy make things worse for them than they already are?

Mr. JOHN. The problem that we run into is that typically new borrowers, lower, middle-income borrowers, et cetera, have a much higher debt-to-income ratio just pretty much by definition because they have got less income there. Typically these are both higher risk loans, and these are loans that require a great deal more day-to-day work to collect. And that increase in cost by making it still harder to issue certain of these—and again, I am not defending the practices that the Fed found to be reprehensible here. But even in the case of what the Senate dealt with yesterday, two of the Democratic Senators expressed very strong reservations about what was being done, specifically because they were concerned that it was going to deny credit to the populations I have been mentioning.

Mr. CONYERS. Well, look, let's put this on a very ordinary level; look what happened to you.

Mr. JOHN. Yes.

Mr. CONYERS. I mean, this wouldn't be made more complicated if we correct the practices that brought it on.

Mr. JOHN. It is not those practices. I am very comfortable with the way the Fed has approached this and the proposals that the Fed has come up with. What I am concerned about is the effects of going beyond the Fed, whether that is some of the proposals like S. 257, the bill that was discussed in the Senate Judiciary about a week ago, or whether some of the other potential changes that would affect this.

Mr. CONYERS. The Durbin bill.

Mr. JOHN. The Durbin bill, yes.

Mr. CONYERS. Let me see what Professor Levitin would add to this before my time is snatched back.

Mr. LEVITIN. Thank you very much, Chairman Conyers.

I think the first point to make is that, while the Federal Reserve's proposed regulations are good, they don't cover everything. They certainly do not cover all of the problematic credit card billing tricks and traps. There is also the question of the 18 months. And while certainly I don't think that banks can implement these regulations overnight flawlessly, 18 months does seem rather long. But I think something that Mr. John said really gets to the heart of the issue.

Mr. John said the card industry has lots of well-paid, smart attorneys—I used to be one of them—or at least I will go with well paid—who their job is to figure out ways to do end runs around regulations. And inevitably, whether it is Congress or the Federal Reserve—and this is the Federal Reserve which has not issued any regulations on this for years—Congress or the Fed are going to be playing catch up. It is going to be a game of whak-a-mole, that as soon as Congress or the Fed puts the kibosh on one particular problematic practice, the card industry is just going to redesign around this.

I think the solution really has to be flipping the whole model of card regulation on its head. Our current model of regulation is disclose, disclose, disclose, and do whatever you want as long as you

disclose it. And now we are moving toward disclose, do whatever you want except for really bad practices, A, B and C. But if you can come up with practices D, E and F, as long as you disclose, that is fine.

This is a model that doesn't work. We have to flip it around. And the way to do this is to say you can't do anything except for A, B and C. And this is a reasonably easy thing to do. Credit cards, their core functions are pretty simple, you lend out money and then charge an interest rate. That is the core function of credit cards.

It is possible to drastically simplify credit cards. Most of the complexity of credit cards is not to serve any particular consumer desire and need; maybe there are a few niche desires. Instead, credit cards are complicated for complication's sake, just like credit card cardholder agreements are complicated for their own sake. The whole point of the complication is to make it harder for the consumer to know what this is going to cost to use. And if the consumer can't figure out what it is going to cost to resolve the balance in the future on the credit card, the consumer can't figure out if the consumer should be using their credit card or which card the consumer should use. It may be smart to use a card, but you have to be able to also distinguish between cards.

So I think that really Congress should start thinking about approaching the credit card regulation in a different manner. It is good to ban the really bad practices, but this is going to be a catch-up game.

Mr. CONYERS. David John, do you find that that is not an unreasonable analysis?

Mr. JOHN. I actually find that that would be quite problematical, because what that does is to make it very hard to implement any sort of innovations that actually would benefit the consumer.

We have seen in the field of insurance regulation, which is handled at the States, that in a number of States, when an insurance company proposes a new product that would change its market share by being very popular with consumers, that in certain States these products are blocked or changed simply to protect the market shares of some of the people who are already in there. What you are doing with that kind of a regulatory standpoint is to make it well worth the while to block innovation so that you can protect your own situation.

Mr. CONYERS. Do you think Senator Durbin's proposal may go in that direction?

Mr. JOHN. I think Senator Durbin's proposal is aimed at bankruptcy and how credit card and high-interest debt is treated in bankruptcy.

Mr. CONYERS. Now, surely the panel is in agreement on this overaggressive marketing of cards. We are still searching my boy's belongings to find out how many credit cards he got from Morehouse this semester already.

Mr. MIERZWINSKI. Chairman Conyers, if I could respond to that, all of the consumer groups concur with that. In fact, we have published reports, which I could enter into the record, on the marketing of cards to young people. The National Council of La Raza has published reports on marketing to Latino families. And all of the major civil rights groups, by the way, support all these strong

reforms. They want cards to be offered to their members, but they want those cards to be offered on a fair basis.

And although Mr. Delahunt has stepped out, I would point out that he has a bill, which Mr. Durbin has a companion bill, that would get at what Professor Levitin has proposed, and that is his Financial Product Safety Commission bill, which would be to have these are the safe ways to market a credit card, and start from there. So we would concur, and all the major consumer groups support that as well.

Mr. WEISS. The other issue, if I may, is not only the availability of credit, particularly to the subprime market, but what type of credit is available to that market. If all that is available is predatory lending, high interest rate, high fees, that is not good. And that type of credit needs to be sharply restricted. And yet it is that type of credit that is one of the biggest money makers for the credit card industry. The subprime market makes more money than does people such as are sitting up on the dais. That is where they make their money, from the high interest rates, from the high fees. That is where they are getting their money, and that is what they want to keep doing because it is so profitable.

Mr. LEVITIN. Mr. Chairman, I would like to amplify something that Mr. Mierzwinski said.

Mr. Mierzwinski pointed out that Senator Durbin's bill, and I believe Congressman Delahunt's analogous bill in the House for a Consumer Financial Product Safety Commission, would, I agree, create a Federal regulator with the ability to say only the following practices are permitted.

Now, Mr. John rightly raises the question of whether this would inhibit innovation. I would submit to you that we have not seen any innovation in the card industry that has been beneficial to consumers in recent memory. And innovation is not all good, there can be positive and negative innovation.

But given the possibility of future beneficial innovation for consumers, the way to handle that is to have a regulatory agency that can respond to industry requests to allow new products, but this needs to be an industry with much, much more regulation.

Mr. CONYERS. Thank you for your generosity, Mr. Chairman.

Mr. COHEN. You are welcome, sir.

Mr. Franks, the Ranking Member, is recognized.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Mr. Chairman, Professor Levitin argued that consumers with higher credit card debt were more likely to file bankruptcy, and I am having difficulty as to why that should surprise us. I am wondering if it couldn't mean that people who prefer to make their purchases in cash, whenever possible, are maybe more financially responsible. I think you can make the argument that jails probably have a higher incidence of having bank robbers in them than grade schools as well, but I feel like that is almost an argument here that would take us in a different direction.

Mr. John, I guess I would ask you the first question. What economic evils would befall this system, our financial system, if the pricing of consumer credit were divorced completely from accurate assessment of risk, or if we divorced it from the insistence on debt-

or responsibility and accountability? What would happen to the credit market?

Mr. JOHN. Well, what we have seen in the case of certain aspects in the housing market and other areas is that the credit would be primarily available to the best quality customers.

One of the things that we have seen, and this is true in pretty much all of the consumer groups, except for the very highest, is that typically an individual will start out at a relatively high-cost credit card or other debt, and as they pay that and as they establish an appropriate credit history, which indicates a lower risk, they either qualify for lower rates or they can move on to other credit cards with lower rates and better terms.

It is really not all that difficult to find a new card once you have gotten a decent credit rating. If you completely divorce that process, then it is going to be much, much harder for mainly three groups; I have mentioned the middle and lower-income worker, but also the first-time borrower, the kids who are first coming out of—in particular, school, they are not coming necessarily out of college—and people who are trying to reestablish their credit after some sort of a problem, to get back on the ladder and build themselves back up.

Mr. FRANKS. Well, Mr. John, I guess that is my concern. If we divorce ourselves from cause and effect, a lot of times, especially in this situation, I think we end up oftentimes hurting the ones that we are ostensibly trying to help here more than we do anybody else. And I am always amazed. I think it goes back to Congress' attitude that sometimes we can repeal law's mathematics here and we make things even worse when we try.

Well, let me ask you this, then, since amendments to the Bankruptcy Code have the potential to distort market decisions and actually increase hazard, wouldn't it be better for us to wait to consider any changes to that code until the Financial Services Committee and the regulators have had a chance to complete their work? What is your perspective?

Mr. JOHN. It strikes me that it would be a much better course to figure out what you are going to be dealing with in the future before you necessarily make any changes. One of the problems that we saw, for instance, in S. 257, in the Senate bill by Senator Durbin, was the idea that if an individual had a single high-cost credit transaction, that they could be completely exempted from the means test. And of course it wouldn't be too hard to imagine a situation where a client went to a lawyer who had a connection with a high-credit lender and suggested that maybe they would like to go out and borrow from a particularly check cashing agency or something along that line so that they could get themselves out of the means test. Now, I would suggest that that would probably end up lowering respect both for the bankruptcy law and of course for the legal profession.

Mr. WEISS. It is also currently prohibited under the 2005 act.

Mr. FRANKS. Mr. John, is there anything that you know that limits the House Financial Services Committee, that prevents it right now from legislating controls on abusive practices that the regulators, for whatever reason, decided not to regulate?

Mr. JOHN. No. Absolutely. They have complete jurisdiction in this area.

Mr. FRANKS. Well, Mr. Chairman, I am going to yield back with a few seconds left. That is a rarity.

Mr. COHEN. Mr. Weiss, let me ask you this; the Federal Reserve has some reforms, 18 months, but are there other reforms you think that need to be adopted that the Federal Reserve did not address?

Mr. WEISS. Well, the 18-month period obviously has been discussed fairly extensively today, and there are serious problems with it. While the provisions are good, I think they are a good first step, I think that there is more that needs to be done. I am seeing daily in my practice debtors who have just been slammed by these fees. And while the proposed regulations will remove some of them, as Mr. John mentioned, there is some very talented and highly paid people whose job it is to figure out ways around them so that they can resume charging the very fees that amount to 39 percent of their profits.

So I think that Mr. Levitin's comments about possibly needing to reverse the standard instead of saying these are prohibited acts, let's look at what is allowed, may be a very good way of stopping the ingenuity of the lawyers who will be looking at this and trying to find loopholes.

Mr. COHEN. Does Professor Levitin or Mr. Mierzwinski have suggestions of things that the Fed didn't go far enough on that should have been changed?

Mr. MIERZWINSKI. Well, first of all, the Federals, many of their changes only apply to your existing balance. The use of your card in the future would be subject to whatever higher rates they would impose on you. Now, I would respectively disagree, I think, with some comments that Mr. John may have made earlier that it is easy for you to go out and get a new card. For the people that are in trouble, it is not easy to go out and get a new card. So we need to prevent the practices, both on a backward basis and on a going forward basis, for the people that are locked in with that one company.

Mr. Dodd's bill in the Senate—the House bill largely tracks the Federal rules, but amends the Truth in Lending Act rather than the Federal Trade Commission Act. The Senate bill goes further, would ban universal defaults completely, and would make it easier for consumers to avoid some of these practices.

In the jurisdiction of this Committee, we strongly believe that the Arbitration Fairness Act should be enacted to get rid of the provision in the card contract that prevents consumers from enforcing their own disputes with credit card companies in court. And that would be a major step forward as well.

Mr. COHEN. Professor.

Mr. LEVITIN. I would agree with all of those points. I would also add in that I think the Federal regulations address double cycle billing, they do not touch its kissing cousin, which is called residual or trailing interest. They say nothing about interchange fees. I think it is crucial that they do not eliminate all universal cross default. They still allow teaser rates. They allow a bundling of re-

wards programs that have nothing to do with extensions of credit and that are funded by interchange fees.

But I also want to make sure that I did not misstate something to Mr. Franks. You are exactly right, that there is nothing particularly surprising about high credit card debt correlating with bankruptcy, that people who are in bankruptcy have debt. What is important to note is that, dollar for dollar, credit card debt has a much higher correlation with bankruptcy than any other type of debt. So a consumer who has $100,000 worth of credit card debt is going to be far more likely to file for bankruptcy than a consumer with $100,000 of any other type of debt.

Mr. COHEN. Mr. Weiss, are there changes you would recommend in the bankruptcy law that pertain either to credit card debt, or any other particular changes besides—and I am not sure if you addressed this or not—the counseling section and the means test?

Mr. WEISS. I mean, counseling and means test, frankly, are largely useless. If you want to have counseling, the time for it is before debt is incurred rather than before you have to file for bankruptcy as sort of a gatekeeper function. It doesn't educate, it doesn't change things, and it really doesn't do anything other than push up the price of bankruptcy.

The means test was I think very accurately described by a friend of mine; if under the old law what we did was wash your car, under the new law, because of the means test, not only do we have to wash your car, we also have to run around your house three times. It has about the same amount to do with washing your car as the means test has to do with preventing abuse in the bankruptcy system. But it delays things, it costs more money, and it doesn't accomplish the goal that was set, which is preventing abuse.

Additionally, frankly, most of the changes that were made in the 2005 act did little to prevent abuse or help debtors. It did significantly increase the cost of bankruptcy and delay the filing. And as was noted earlier, that, with the sweat box model, is exactly what was intended. The longer that people are delayed from filing, the more money is made by the credit card issuers in particular. And that seems to have been one of the goals of the 2005 act.

Mr. COHEN. My time has expired. I am going to yield to Mr. Delahunt. And if you have a question of Mr. John, I think he needs to go, and possibly Mr. Weiss. So maybe you can direct those questions to them first. And don't miss your plane or don't miss getting your bill paid.

Mr. DELAHUNT. Well, they get to stand up because if I don't have sufficient time, I am going to request a second round.

I hear what you all say, but I am gravitating toward what Mr. Levitin says about a real fundamental shift in terms of how the credit card industry is viewed and how the rules of the marketplace should play. Because we can continue to tweak the edges, we can continue to address—and I think this goes with you, too, Mr. John—we can address the obvious practices that I don't think anyone here would encourage. But what you were just saying, Mr. Weiss, in terms of the sweat box and the delay advantaging the credit card companies, I believe that is really indisputable when you examine it. But I think what we fail to understand, not only does it enhance, if you will, the pain for the bankrupt, but it dis-

advantages other unsecured creditors and hurts the retailer because they are receiving a diminished pro-rata share.

Could you expand on that? Am I correct, first of all? Because if you are interested in the retailer in America, if you are interested in commerce in America, you have got to take and put this issue into this equation. It isn't just about the credit card industry, it is about business in America.

Mr. WEISS. By definition, money that is paid pre-bankruptcy is unavailable post-bankruptcy to pay other creditors. While in most chapter 7 cases there are no distributions to any creditors, in chapter 13 in particular, where the unsecured creditors are typically put in a pool, there those payments can seriously disadvantage creditors that don't charge these fees, that don't charge exorbitant interest rates.

Mr. DELAHUNT. Such as?

Mr. WEISS. Such as Bloomingdale's, such as Macy's, such as dearly lamented Hecht's, or Garfinkel's, or Raleigh's. These businesses will typically not charge these types of fees. And when a proof of claim comes in in a chapter 13 case for Chase or Bank of America, you have got all of these fees, you have got all of these costs added, artificially inflating the amount of money that they are claiming. And, therefore, they get a much larger pro-rata share than the other creditors.

Mr. DELAHUNT. Professor Levitin.

Mr. LEVITIN. I would add to that, it is not just the Bloomingdales and the Hechts of the world that are disadvantaged, it is also really the small businesses. It is the general contractor who did work on my house before I filed, it is my doctor or my dentist. They are small businesses, and they are going to have their pro-rata claim diminished relative to the card issuer. It is going to be tort victims. It is going to be the Federal Government, to the extent that it has nonpriority tax claims. It is going to be the local and State governments. 2005 amendments benefited the credit card industry at the expense of all other unsecured creditors. But what is even worse, it benefited the credit card industry at the expense of a homeowner's ability to avoid foreclosure.

To the extent, in chapter 13, you have less disposable income available, that you are forced into 13, that is going to—so the means test is going to force more people into 13. And it is going to mean that your disposable income in 13 is going to be tied up. If you had been able to file for chapter 7, your disposal income would have been available to reach a deal on the outside with your mortgage lender or to do a reaffirmation. That is much more difficult for people to do now after 2005.

Mr. WEISS. And additionally, they also do not have the ability, when in a chapter 13, to be able to go out and resume spending, resume contributing to the economy in that fashion because their credit is tied up, their income is tied up in the bankruptcy court.

Mr. DELAHUNT. You know, Mr. John talks about the Federal Reserve, you all do talk about the rules that have been promulgated but are going to take 18 months to implement because of computer problems. And yet, you know, the Federal Reserve, tell me if I am inaccurate, was conferred the power back in 1994 to deal with the deceptive practices in mortgages and never exercised that author-

ity, didn't implement it. And when you begin to trace back how we arrived at the financial crisis which we see all around us, the so-called subprime problem, the ability to enforce, the authority was there, and it didn't happen.

I mean, I am not really comfortable relying on the regulator that doesn't regulate for whatever reason. Maybe it is under-resourced. Maybe it is because of a particular perspective. But relying on the Federal Reserve has not produced a benefit to the American financial service system as far as I can determine, because it was clear in 1994 they had the authority, and if they had exercised it we wouldn't be in the mess that we are in now.

Comments?

Mr. MIERZWINSKI. Mr. Delahunt, I would totally agree with you. The fact is I would have to add a couple of other agencies to your list.

Mr. DELAHUNT. Add them.

Mr. MIERZWINSKI. I totally agree first though that the Fed missed the opportunity to issue HOPA regulations that they were given the authority do in 1994 until after the consequences of the meltdown had already hit us. And then the regulations they put out just a year or two ago are too weak and unacceptable.

But the failure of the Office of the Comptroller of the Currency and the Office of Thrift Supervision to regulate their entities and the taking away of State Attorney General authority over these national banks and the companies that were actually State-chartered institutions but were affiliated with national banks, the preemption was extended there. So we have a combination of taking away the State enforcer's lax regulation at the Federal level, the inability of consumers to do private enforcement, the concentration of the industry into just eight companies, and the regulatory arbitrage that the companies are allowed to switch the charter in order to get a regulator that is a better deal for them, has all contributed to this crisis. And it is why all the consumer groups are supporting your proposal, the Financial Products Safety Commission, one regulator for consumer protection. We also want to reinstate State Attorney General authority over the financial system. And that is a big fight that we are having.

It used to be that the industry talked about the trial lawyers as bad people. Now they refer to rogue Attorneys Generals, and Attorneys General are the best consumer cops on our beat in many ways case—in fact, in almost all the cases I can think of, And we need to change that mindset. We need to reinstate their authority, too.

Mr. DELAHUNT. Mr. Chairman, I am going to ask for a second round because I would like to get into the issue of the underwriting criteria of credit card issuers, as well as high interest issues as far as credit card issuers are concerned. But I know some of you have to leave. And I know Mr. Franks——

Mr. COHEN. Mr. Franks has generously consented that you go on because you missed the first round. You don't know, but you are in the second round.

Mr. DELAHUNT. It is always good to be here in the last round.

Mr. COHEN. I remember a few prize fighters that didn't realize it was second round.

Mr. DELAHUNT. Some have suggested that.

We all have those anecdotes about credit cards going to dead people. My daughter, along with Chairman Conyers', about 10 years ago received a check in the mail for $2,500—I think it was Providian—have a good spring break. Thank God I caught it or she would have had one hell of a spring break. We talk about addiction. I mean, we are trying to regulate tobacco. I think there is some analogies here.

But anybody, anybody can get a credit card. I mean, I know people that are in bankruptcy that were getting credit cards while in bankruptcy. Talk about an Alice in Wonderland world. I mean, they were just pushing this garbage out, okay, it didn't make any difference. And I understand in the credit card industry it is transaction-based and it is high interest rates. And I think the concept of the sweat box really kind of says it all. They don't care about the principle, just give me all of the different fees. You have to have a mainframe computer to calculate the fees. That is where the money is.

And Mr. Chairman, Mr. Franks, neither one of you were here, but I can remember filing a bill—so that is the underwriting—where we were going to cap interest rates, much like the Durbin bill, but we were willing to do it at 100 percent, 100 percent. And the credit card industry said no, we can't accept that; 100 percent. I used to be a prosecutor before I came here. We used to refer to that as "the dig." If you did organized crime investigations into loan sharking, you know, I never ran across 100 percent, plus all of the penalties that were implicated.

So I guess I have a disagreement with you, Mr. John. In real life there has to be some parameters and some boundaries. So if all of you could take a shot at, what do they do in terms of underwriting? How do they get to it? Do they have any underwriting at all?

Mr. WEISS. What you used to call loan sharking, the credit card companies now call a good business model. I get clients all the time who come to see me and tell me that, by the way, I just got—and they are incredulous—yesterday I got a pre-approved credit card with a $25,000 limit; what should I do with it? Because it is sort of like, well, I may be able to make this work if I had a little bit of money and a little bit more time. There is virtually no underwriting that is done.

When you look at the subprime market in particular, it is a free fall zone. It is, we will give you a card because the risk that you won't pay is more than covered by the fees and the interest and the cards.

Mr. DELAHUNT. But Mr. Weiss, by doing that, what they are doing is they are eroding the economy. They have created the debacle, that mindset that we currently have to deal with that has put the global economy at risk, just let it rip, no rules, no regulations. It is more than the Wild West. I mean, it is really, really dangerous. This is not just protecting the consumer, this is protecting every taxpayer, every single American business that does business in a way that is based upon recovering the principle, producing a product, and getting paid for it—and, yes, making a good profit. But how did this all happen? How did this happen?

Mr. WEISS. It happened because there is no oversight and no regulation.

Mr. DELAHUNT. Would the Ranking Member want me to yield to him?

Mr. FRANKS. Go ahead and finish.

Mr. DELAHUNT. Okay. Mr. Levitin.

Mr. LEVITIN. I think the first step in this happening, we would have to go all the way back to 1978. That is when the Supreme Court handed down the decision in Marquette. Marquette dealt with the question of whether a federally chartered bank could export the interest rates of its home State to another State. So if a federally chartered bank was based in Massachusetts and Massachusetts chose not to regulate interest rates, could that bank then export interest rates to Arizona, and what ability would Arizona have to protect its consumers in its wisdom against the Massachusetts bank?

The Supreme Court ruling on—not on any particular policy matter, but rather ruling on the language of the 1863 National Bank Act—this was the legislation that Abraham Lincoln used to finance the Civil War—ruling on the particular statutory language there, which was dealing with a world where there were usury laws and just a different world altogether, the Supreme Court said yes, federally chartered banks can export their interest rates to other States. That is why we see most credit card issuing banks basing themselves in Delaware or South Dakota.

Mr. DELAHUNT. South Dakota, right.

Mr. LEVITIN. Incidentally, the two Senators on the Senate Banking Committee who voted against Senator Dodd's legislation yesterday are from Delaware and South Dakota. That is why we see banks flocking to centers of lax regulation and then exploiting their interest rates to States that actually do want to regulate. This goes against the whole principle of federalism, that States should be able to protect their own citizens how they see fit. And if one State wants to do it differently than another, it should be allowed to do that.

Mr. DELAHUNT. Mr. John, let me just ask you a question. Would you agree there ought to be a cap on interest involving a credit card?

Mr. JOHN. No.

Mr. DELAHUNT. You would disagree with my amendment way back when, when I had dark hair and was as articulate as Mr. Cohen, and tried to cap the interest rate at 100 percent? You would say no, you can't do that?

Mr. JOHN. I would say no, and I would assume that the banks said no because they realized that once you have established the principal at 100 percent, the next step will be to reduce it to 50, and the next one will be to lose, et cetera, et cetera, et cetera. And that has already been proven in many, many situations.

As a matter of fact, I used to work around the corner in the Banking Committee, and at the time there was high interest rates in the Jimmy Carter regime. We had the State of Arkansas coming in every 2 years so that we would lift the cap that was within their State Constitution because it didn't fit.

It is one thing to talk about something in normal times, but when you had a mortgage interest rate for a 30-year conforming

mortgage in October 1981, I believe it is, or somewhere in that neighborhood, that reached slightly over 18 and a half percent——

Mr. DELAHUNT. I am talking 100 percent.

Mr. JOHN. I understand that. But as I say, once you establish the principal, then you start to get into that.

Now, I must apologize. I have a 6-year-old who wants me to read stories to her tonight.

Mr. DELAHUNT. That is far more important than listening to me rant.

Mr. JOHN. I live in West Virginia, and I can't miss my train. So I apologize for that.

Mr. DELAHUNT. Thank you so much.

Mr. COHEN. Thank you, sir. And Mr. John, thank you for coming. Mr. Brian Nolan was here earlier, he has left. He is the head of your Board of Regents for West Virginia and as fine a public official as I have ever met. You are lucky to have him.

Read your daughter a nice story.

Mr. Franks, you are recognized.

Mr. FRANKS. Thank you, Mr. Chairman. And thank you, Mr. John.

Mr. Chairman, I have just been thinking here a little bit. You know, there has been a lot of talk about how this economy got to where it is, and I know that there are sincere opinions that diverge pretty significantly. But I am going to at least submit that the core reason why we are in trouble today is irresponsible borrowing and spending. And I actually believe that government, this Congress, created some incentives out there some years ago for people to borrow and spend irresponsibly, and even put pressure on lending institutions to make those loans. I will give you one example, that being the Community Reinvestment Act. And of course the goal was to help those who couldn't get loans very easily, to try to make the playing field a little easier for them to deal with. And I applaud the goal. But once again, it divorced financial transactions from responsibility.

Chase Bank was sued because they weren't making enough subprime loans, and they finally acquiesced and said, okay, we will make those subprime loans. And anybody can make the case that the regulator should have caught this irresponsible borrowing and spending—a lot of people will—but it certainly does not alter the fact that this government created direct incentives for that to occur. It doesn't alter the fact that if the regulators had caught it, that they would have been dealing in an environment of pressure from the Congress.

Not long ago, this Congress believed that the credit markets, keeping credit available to people, was so important that we voted on a $700 billion bailout for the credit market, essentially, because we believed that that was important, we believed it was important to happen. And my concern here is that, once again at the core, the heart of it, is that we have the actual crucible matrix, if you will, irresponsible borrowing and spending. And I am afraid that once again here in the credit card situation we are trying to divorce responsibility from transaction. If we don't somehow give the lender, whoever they are, whatever their motivations are, if there isn't some ability to match that transaction with risk, if there isn't some

ability to gauge whether or not this will be paid back, if there isn't some effort to make sure that the borrower is held responsible, then the entire process becomes unbalanced.

The Chairman here mentioned that people sometimes have addictions to buying and things like that, and I believe he is right. I believe the same thing happens with gambling and things like that. But if we take away the responsibility in that process, I think we only exacerbate those things. And I hope in the process here—what I see is us going in the wrong direction in general. I think we are bailing out the credit markets and we are bailing out those who have made bad borrowing and spending decisions. And now, in order to facilitate that, we are now, as a government, borrowing and spending irresponsibly.

And ultimately, try as we will, we will not repeal the law's mathematics or that fundamental need to balance our transactions with responsibility because ultimately somebody has to pay for it.

And I thought Margaret Thatcher put it best: "The problem with socialism is that soon enough you run out of other people's money." And I think that is where we are going. I am concerned, as I apply that to this hearing here, that we are going in the same direction with the credit card. We are saying to people that make bad—maybe they were sold a bill of goods, maybe people were sold the wrong house, maybe the brokers did it. But when people aren't held ultimately responsible, then in the final analysis the whole system breaks down and it actually creates an incentive for people to abuse the process.

And what was the final result? The final result is that in this economy, the poorest of the people, those that we ostensibly were trying to help in the first place, are the ones that are being crushed. And I would submit that credit card availability has helped a lot of poor people make purchases that they never could have otherwise. I think it has helped so many of them in a huge way. And if we are not careful here, we will make their access to credit impossible because we simply cannot repeal the laws of mathematics or divorce responsibility from financial transaction.

And that is more of a speech than it is a question. So I am going to stop right there because my light is red. Thank you.

Mr. COHEN. Thank you, Mr. Franks. Thank you, Mr. Delahunt, for your contributions. I would like to thank all the witnesses for their testimony.

Without objection, Members have 5 legislative days to submit any additional written questions which we will forward to the witnesses and ask you to answer as promptly as you can to be made part of the record.

One of my questions I will send you—and I will just give it to you orally—is I would like each of you to give me a brief little paper on what you think should be changed in the bankruptcy laws and what should be changed in the credit card laws. And if you would submit those, we will make that part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any other additional materials.

Again, I thank everyone for their time and patience. The hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 5:10 p.m., the subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

RESPONSE TO POST-HEARING QUESTIONS FROM ADAM J. LEVITIN,
ASSOCIATE PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on Consumer Debt: Are Credit Cards Bankrupting Americans?
Thursday, April 2, 2009

Adam J. Levitin, Esq., Georgetown University Law Center

Questions from the Honorable Steve Cohen, Chairman

1. **Other than repealing BAPCPA's means test and credit counseling requirement, are there bankruptcy law changes that you could suggest that could help consumer debtors?**

Yes. First, Congress could provide that claims of creditors who violated consumer protection laws (including the Truth-in-Lending Act) in respect to the debtor are disallowed, both in the hands of the original creditor and any assignee.

Second, Congress could require that creditors who submit claims based on extensions of credit that would be subject to the Truth in Lending Act submit with their proof of claim a sworn affidavit from their attorney, under penalty of perjury, declaring that at the time the creditor extended credit, the creditor had a reasonable basis to believe at that the consumer would be able to repay the loan in full and on time or, in the case of a revolving line of credit, within a reasonable amortization period (3-5 years).

2. **Do you see parallels between credit card and subprime mortgage lending practices and business model? If so, which ones give you the most concern and why? Are there any differences between the two that either concern or reassure you?**

Yes. There are three important parallels between credit card and subprime mortgage lending. First is the heavy use of securitization, which transfers credit risk from the original lender to investors. To the extent that the risk is transferred it encourages the lender to engage in riskier lending. There are important distinctions between credit card and mortgage securitization, but the basic risk-transfer principal is what drives all securitization.

Second, both credit card and mortgage lending has become increasingly fee-driven. Credit card issuer revenue is increasingly driven by fees—both interchange and various consumer fees. Likewise, mortgage lending has come to feature "points"—prepaid interest—and padded closing costs in order to generate fee income that has no connection to credit risk.

Third, both credit card and subprime mortgage lending rely on "stated income" for underwriting. This means that underwriting capabilities are relatively limited. Stated-income underwriting is particularly problematic for unsecured loans like credit cards that cannot look to collateral value for recoveries upon default. Arguably the card industry compensates for this with pricing, but the use of stated income loans in both types of lending goes to a larger point—neither credit card lending nor subprime mortgage lending requires consumer repayment of principal for the loan to be profitable to the originating lender.

Finally, both credit cards and subprime mortgages share many product design features that are intended to lure consumers into debt by disguising the true cost of the debt. Many credit cards feature teaser interest rates, just as many subprime mortgages are so-called hybrid adjustable-rate mortgages that feature a low teaser rate for 1-3 years and then an adjustable rate thereafter.

3. If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.

In the hearing Chairman Cohen asked me to elaborate on the comparison between the addictive qualities of credit and drugs. While there are some parallels as I observed earlier, the more apt comparison is between credit cards and cigarettes. Cigarettes are by nature both addictive and deadly. But the tobacco industry has, to its great disgrace, labored to enhance the addictive qualities of cigarettes. That is to say, the product has been deliberately manipulated to play upon consumers' weaknesses. Sadly, the same is true of credit cards.

Irresponsible borrowing often has unfortunate consequences, just like consuming tobacco products. And, like the tobacco industry, the credit card industry has deliberately manipulated its product to take advantage of consumers' weaknesses. Credit cards are designed to exploit consumers' cognitive weaknesses. For example, credit card pricing has shifted over the past decade or so from being primarily purchase interest rates and annual fees, to being penalty interest rates and contingent fees like late fees and overlimit fees. This shift in pricing preys upon consumers' optimism bias—namely consumers systematically underestimate the likelihood that they will pay late or go overlimit or otherwise default, and therefore use credit cards more than they otherwise would if they accurately intuited the cost of using cards.

Likewise, the sheer number of credit card price points makes its virtually impossible for consumers to determine the cost of revolving a balance on any particular card. As a result, consumers focus on a couple of price points like the purchase APR, when the more important pricing might be in contingent price points that consumers are likely to ignore.

Another example is credit card billing statements, which frequently feature the monthly minimum payment more prominently than the total balance. Doing so encourages consumers to pay the minimum payment and revolve a balance rather than paying off the balance.

Yet another example is that merchants are forbidden from surcharging for credit cards, even though federal law gives them the right to offer a discount for cash. Mathematically a credit surcharge is the same as a cash discount. But economically they are quite different. Consumers react very differently to surcharges than to discounts. A credit surcharge elicits a strong negative reaction, whereas a cash discount elicits a mild positive reaction.

This list is not meant to be an exhaustive cataloging of the way in which the card industry has redesigned its products to exploit consumers' cognitive weaknesses. But I hope they are sufficient to underscore the analogy between credit card issuers and tobacco companies: both market potentially dangerous products to the public and both have intentionally manipulated their products to make consumers use them more and with more harmful results.

RESPONSE TO POST-HEARING QUESTIONS FROM BRETT WEISS, ATTORNEY, GREENBELT, MD

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Brett Weiss, Esq., National Association of Consumer Bankruptcy Attorneys

Questions from the Honorable Steve Cohen, Chairman

1. **In your written testimony, you stated that you would like to Congress to enact, amoug other things, certaiu specific exceptious to BAPCPA's means test. What specific exemptions to BAPCPA's means test would you like to see enacted and why?**

The means test, which served as a cornerstone of the 2005 Bankruptcy Act amendments (BAPCPA), was premised on the assumption that there was widespread abuse in the consumer bankruptcy system and that many who filed chapter 7 bankruptcy cases could afford to pay a significant portion of their debts. As my colleague, Henry Sommer, immediate past president of the National Association of Consumer Bankruptcy Attorneys (NACBA) testified before this Subcommittee in May 2007, the reality is that there never was widespread abuse and the experience under the new law has confirmed as such. According to Mr. Sommer, only about one half of one percent of debtors filing for bankruptcy had been charged with abuse the mean's test, even though the threshold is very low (a debtor can be charged with abuse if it is determined that he or she can pay as little as $100 toward the debt.

Perhaps the biggest impact of the means test and other provisions is that the cost of filing for bankruptcy has been dramatically increased. For that reason, NACBA has supported legislation that makes exceptions to the means test in certain circumstances. For example, NACBA supports legislation that would provide an exception to the means test in those circumstances where the bankruptcy filing resulted from a high cost consumer credit transaction. Likewise, NACBA supported the National Guard and Reservists Debt Relief Act of 2008 (PL 110-438) which provides for an exception to the means test in certain circumstances involving our military personnel. The provisions of that law will expire in the not too distant future.

There may well be equally compelling categories of debtors who would benefit from an exception to the means test. We would be happy to explore this possibility with the Committee and to assist in designing appropriate remedies.

2. **If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.**

NACBA has no additional points to make at this time. We greatly appreciate the Committee's interest in exploring issues related to consumer bankruptcy and look forward to working with you to ensure that financially vulnerable consumers are treated fairly in the bankruptcy process.

RESPONSE TO POST-HEARING QUESTIONS FROM EDMUND MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP

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Edmund Mierzwinski, U.S. Public Interest Research Group

Questions from the Honorable Steve Cohen, Chairman

1. **In your written testimony, you stated that you would like to Congress to enact, among other things, certain specific exceptions to BAPCPA's means test. What specific exemptions to BAPCPA's means test would you like to see enacted and why?**

Thank you again for the opportunity to testify before the committee. My most important recommendation for exceptions to the means test would be to enact an exception for high-cost debt from the means test. See, e.g., S. 257 (Whitehouse). The bill defines high cost debt as:

> `(A) the sum of 15 percent and the yield on United States Treasury securities having a 30-year period of maturity; or
> `(B) 36 percent.'.

2. **If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.**

Not at this time, I believe that between my testimony and that of the other pro-consumer witnesses, Professor Levitin and Mr. Weiss, we laid out a clear case describing the hardships that BAPCPA and the credit card companies have imposed on working families. Section 201 of the newly-enacted Credit Card Accountability, Responsibility and Disclosure (CARD) Act (PL No: 111-24) does address one flawed provision of BAPCPA and will require an improved, improved disclosures on monthly account statements of the actual length of time consumers making only the minimum payment will have to pay off their cards. Other matters under jurisdiction of the Judiciary Committee were unfortunately not addressed by this laudatory new law. In particular, we urge enactment of the Arbitration Fairness Act, HR 1020, to eliminate forced arbitration clauses in credit card and other consumer contracts. In addition, amendments to reinstate long-eliminated usury ceilings were rejected.

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