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BEFORE THE SENATE JUDICIARY COMMITTEE

“Credit Cards and Bankruptcy: Opportunities for Reform”

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Senator Whitehouse, thank you for holding this hearing and for inviting us to testify today regarding ways in which bankruptcy laws can be improved to encourage reform of credit card practices and to help consumers in dealing with payment of credit card debt. I testify here today on behalf of the low income clients of the National Consumer Law Center,¹ as well as on behalf of the National Association of Consumer Bankruptcy Attorneys.² The clients and constituencies of these groups collectively encompass a broad range of families and households who have been affected by current credit card practices.

My testimony is based in part on over twenty-five years experience representing consumers in debt collection, bankruptcy and foreclosure defense matters, initially as an

¹ The National Consumer Law Center, Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws and bankruptcy, including Consumer Bankruptcy Law and Practice (8th ed. 2006) Truth In Lending, (5th ed. 2003) and Cost of Credit: Regulation, Preemption, and Industry Abuses (3d ed. 2005) and Foreclosures (2d ed. 2007), as well as bimonthly newsletters on a range of topics related to consumer credit and bankruptcy issues. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

² The National Association of Consumer Bankruptcy Attorneys (NACBA) is the only national organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. NACBA has more than 3,100 members located in all 50 states and Puerto Rico. NACBA has been actively involved in promoting reasonable and fair bankruptcy legislation since it was founded in 1992.

attorney with Rhode Island Legal Services and head of its Consumer Unit. In this work I encountered numerous clients whose problems with payment of credit card debt caused them to seek bankruptcy relief. In addition to my current work at NCLC in which I train and consult with attorneys, credit counselors and housing counselors throughout the country on a variety of consumer matters, I continue to assist attorneys at Rhode Island Legal Services with bankruptcy and foreclosure cases.

In my experience working with consumers when at Rhode Island Legal Services, and in my continuing work with advocates nationwide, I have found that many 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 national survey of indebted low and middle income households, seven out of ten households of all ages reported using their credit cards as a safety net, relying on cards to pay for car repairs, basic living expenses, medical expenses or house repairs.³

It is also my experience that few consumers borrow money on credit cards without intending to repay it. 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).⁴ These plans to repay, however, easily

³ CENTER FOR RESPONSIBLE LENDING, DEMOS, THE PLASTIC SAFETY NET: THE REALITY BEHIND DEBT IN AMERICA 10 (October 2005), *available at* <http://www.responsiblelending.org/pdfs/DEMOS-101205.pdf>.

⁴ 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” at 16 (June 2006) *available at* <http://www.federalreserve.gov/boarddocs/rptcongress/bankruptcy/bankruptcybillstudy200606.pdf>.

change, often due to unforeseen, adverse events such as illness or divorce. Other consumers fall into traps set by credit card companies and do not always know that they are borrowing at an unaffordable pace. Even small setbacks, such as using a credit card for a supply of prescription drugs or to repair a home furnace, can send consumers into a spiral of late fees, over-limit fees and increased interest rates that become impossible to escape.

This is particularly true for older consumers with diminished incomes after retirement or those who unexpectedly lose income due to disability or death in their households. There is little margin for error for these consumers.

Numerous researchers have highlighted the connection between the increase in credit card debt and increases in bankruptcy filings.⁵ Thus, Senator Whitehouse, I applaud your efforts to explore legislative changes to our bankruptcy laws to assist borrowers who have been pushed into bankruptcy due to credit card debt.

Specific Practices That Harm Consumers

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

⁵ For an excellent summary of these studies and an analysis tracking the link between credit card debt and bankruptcy, see Ronald J. Mann, “Credit Cards, Consumer Credit & Bankruptcy”, The University of Texas School of Law, Law and Economics Research Paper No. 44 (Revised March 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=690701.

- 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 (“revolvers”), not from convenience users who pay off their cards. 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 consumers’ credit limits, and encouraging them to take cash advances at high rates or to increase spending to get rewards. All of this is done with little attention to whether the consumer can actually afford to borrow at these rates.

While many of these practices alone or in combination can lead to financial trouble for consumers, the focus of my testimony will 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 include cash advance, balance transfer, wire transfer fees, late and

over-limit fees. Credit card issuers have made these fees higher in amount, they impose them more quickly, and assess them more often. 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 now over \$32. Average over-limit fees have similarly jumped from \$14 in 1996 to over \$30.

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 can be as high as 30% to 40%.⁶ The new terms apply to the old balance – leaving consumers stuck to pay often high balances at interest rates far higher than was originally agreed, with devastating consequences. This practice is especially outrageous when applied retroactively.

“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 numerous examples of consumers who play by the rules and try to pay their debts, but who are driven hopelessly into default by their credit card company.

⁶ See Kathleen Day & Caroline Mayer, *Credit Card Fees Bury Debtors*, Washington Post, Mar. 7, 2005, at A1.

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.” The following consumer stories help illustrate this point:

1. Mr. L, a Rhode Island senior who recently passed away, went to Rhode Island Legal Services for advice on credit card problems. He was concerned because although he was paying more than half of his income each month on several credit cards, he seemed to be making little progress in paying off the accounts. A review of his card statements confirmed his concern. In the all too common situation, at some point after he had stopped using his cards, excessive interest rates and other fees absorbed all of his payments and even left him with balances that kept increasing.

For example, by December, 2006, the balance on one of his credit cards had increased above the \$9,100 credit limit to \$10,145, despite regular payments and no actual purchases or advances made above the credit limit. The statement for that month showed that he had made a \$200 payment in November. However, an interest charge of \$272.87 based on a 32.24% APR had been assessed, as well as a \$39 late fee. Not only did his \$200 payment not cover the periodic interest charges for the month but it left him further behind by \$111.97.

Mr. L eventually stopped making payments on his credit cards after realizing that repayment was impossible. He spent the last years of his life responding to collection actions.

2. A consumer in Ohio, Ruth Owens, stopped using her credit card, made no further purchases or cash advances, and tried to pay off her debt to Discover Bank.⁷ At that time, she owed \$1,963. Over the next six years, Ms. Owens made \$3,492 in payments to Discover Bank. One might assume this was enough to pay off her debt. After all, if Ms. Owens had made the same payments on a \$2,000 loan with interest at 21% annual percentage rate (the usury limit in many states), her debt would be paid off.

During the six year period before her account was sent for collection, not one penny of Ms. Owens' \$3,492 in payments went to reduce her debt. During this time, Discover Bank charged Ms. Owens various fees that consumed all of her payments and caused her debt to grow even larger. The following fees and interest were charged to Ms. Owens' account:

Fees and Interest

Over-limit Fees	\$ 1,518.00
Late Fees	\$ 1,160.00
Credit Insurance (CreditSafe) ⁸	\$ 369.62
Interest and Other Fees	\$ 6,008.66
<u>Total</u>	<u>\$ 9,056.28</u>

⁷ Ms. Owens' experience with her credit card company is discussed in detail in *Discover Bank v. Owens*, 822 N.E.2d 869 (Ohio Mun. 2004).

⁸ Like many card customers, Ms. Owens was being charged for one of the numerous insurance-like products sold by card companies. Often, these products are sold through high-pressure telemarketing sales. In this case, Ms. Owens was charged approximately \$10 per month for a Discover card product called CreditSafe Plus, which apparently provided for a suspension of payments and finance charges if Ms. Owens became unemployed, hospitalized, or disabled. Since Ms. Owens was already on Social Security Disability and unemployed, the CreditSafe product presumably would apply only if she became hospitalized. Ms. Owens was no doubt paying for a product that would likely never benefit her.

Despite having received substantial payments for six years from Ms. Owens (all that she could really afford), Discover Bank claimed that she still owed \$5,564 when it filed a collection lawsuit against her in an Ohio court. *In other words, after having paid \$3,492 on a \$1,963 debt, Ms. Owens' balance grew to \$5,564.*

Ms. Owens would have been far better off if she simply stopped paying Discover Bank years earlier and had them sue her in state court. If Discover Bank had obtained a court judgment for \$2,000, all of the card fees and high-rate interest would have stopped and Discover would have then been entitled to 10% or less interest per year under Ohio law. Rather than have her debt increase, Ms. Owens' payments would have paid off the debt in full in approximately 4 years.

When Discover Card sued Ms. Owens in state court, she submitted the following handwritten statement to the court:

I would like to inform you that I have no money to make payments. I am on Social Security Disability. After paying my monthly utilities, there is no money left except little food money and sometimes it isn't enough. If my situation was different I would pay. I just don't have it. I'm sorry.

The Ohio judge assigned to the collection case found that Ms. Owens was not a deadbeat. He stated that her “instincts were always that she wanted to plug away at meeting her financial obligations. While clearly placing her on the moral high road, that same highway unfortunately was her road to financial ruin. How is it that the person who wants to do right ends up so worse off? It is plain to the court that the creditor also bears some responsibility.”⁹

⁹ Discover Bank v. Owens, 822 N.E.2d 869 (Ohio Mun. 2004).

3. With 8 kids, 13 grandkids and 10 great-grandkids, Elaine had a lot of gifts to buy and she enjoyed buying them.¹⁰ She didn't mind working to pay for those gifts, either. There was enough money to keep current on her credit accounts, each with small balances that she mostly used for gift buying. She was going strong at age 71, working as a cleaning lady in the Manchester, New Hampshire, City Hall and sewing wedding gowns at home on the side. Until, that is, she had a stroke.

Elaine's illness eventually improved but did end her 59-year working career. Simultaneously, it launched her on an all-too-familiar credit card trap even though the total owed on her credit accounts was little more than \$8,000. The big culprit in Elaine's case was a tidal wave of extra charges once she fell behind on her payments.

The *average* interest rate on her seven cards was over 26%, with none lower than 22.5%. One typical credit card tacked on a \$30 late fee, a \$30 over-limit fee and a \$3.50 account maintenance fee every month. The annual interest rate on that card was 27.74%. Another card had a 28.99% interest rate, adding a late fee of \$39, an over-limit fee of \$35 and a finance charge of \$20.93 on a recent bill. Penalty charges on all her accounts tacked on hundreds a month in new debt.

Elaine managed to pay off two of her cards in full but was paying \$400 a month in minimum payments to keep the others going. She was on the verge of getting ahead on another card's balance when a \$69 annual fee put her back behind. On a fourth card a \$59 annual fee put her over her credit limit, triggering additional penalty charges. In any

¹⁰ This consumer's story is recounted in a report issued by the National Consumer Law Center, *The Life and Debt Cycle Part One: The Implications of Rising Credit Card Debt Among Older Consumers*, Deanne Loonin, July, 2006.

event, payments of \$400 a month that weren't denting her balances clearly would not be sustainable on her \$735 monthly Social Security check, her only income after the stroke.

Credit Card Accounts in Bankruptcy

Consumers file bankruptcy as a last resort. By the time they do file bankruptcy, their pre-bankruptcy payments have been diverted away from paying off their charge balances for so long that account balances are typically loaded up with interest and fees. This can be demonstrated by the claims filed by credit card creditors in chapter 13 bankruptcy cases.

For example, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it files in chapter 13 bankruptcy cases.¹¹ In its findings in support of the Order, the bankruptcy judge listed claims filed in eighteen separate cases broken down as between principal and interest and fees. On average, interest and fees consisted of more than half (57%) of the total amounts listed in the claims. In one case (No. 03-20018), 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 (No. 03-100157), 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 charges made by the consumers. And once consumers file a chapter 13 case and their delinquent debt is sold at pennies on the dollar, creditors will not allow consumers to pay off the debt for that amount or some reduced amount. To compound

¹¹ *In re Blair*, No. 02-1140 (Bankr. W.D.N.C. filed Feb. 10, 2004).

matters, debt buyers routinely file claims that do not have documentation and are difficult to verify.

A bankruptcy case from Virginia tells the story of another consumer's efforts to avoid bankruptcy.¹² During the two year period before she filed bankruptcy, the 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, overlimit fees, bad check fees, and phone payment fees, the balance on her account 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.

Proposals for Change

The current economic crisis has made it even more impossible for many consumers to repay debts. Declining property values and the home foreclosure crisis have eliminated the option many consumers previously used to repay credit card debt by cashing in on home equity. Now more than ever Congress should enact laws which encourage credit card companies to work with payment troubled consumers, and most importantly, to limit excessive interest and fees. We believe that S.3259, introduced by Senator Whitehouse, is a strong step in that direction.

¹² *In re* McCarthy, No. 04-10493-SSM (Bankr. E.D. Va. filed July 14, 2004).

By requiring that claims filed on “high cost consumer credit transactions”, as defined in S.3259, are subordinated to all other claims in a bankruptcy case, the bill will give the credit card industry an incentive to keep interest and costs below the definitional trigger. We support this change, though we recommend that an even stronger deterrent would be achieved if the legislation provided for the disallowance of the claim.

S.3259 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.” We also support this provision as it would help some consumers avoid potential litigation costs in proving that a bankruptcy filing was not abusive. We believe the provision could be improved by including some type of categorical exemption from the means test for consumers having high cost consumer debt without the need to prove that such debt caused the bankruptcy filing. Especially for debtors below the median income, the expense of proving causation might eliminate any benefit gained by an exclusion from the means test.

John Rao is an attorney with the National Consumer Law Center, Inc. Mr. Rao focuses on consumer credit and bankruptcy issues and has served as a panelist and instructor at numerous bankruptcy and consumer law trainings and conferences. He has served as an expert witness in court cases and has testified in Congress on consumer matters. Mr. Rao is a contributing author and editor of NCLC's *Consumer Bankruptcy Law and Practice*; co-author of NCLC's *Bankruptcy Basics*; *Foreclosures*; and *Guide to Surviving Debt*; and contributing author to NCLC's *Student Loan Law*; *Stop Predatory Lending*; and NCLC Reports: *Bankruptcy and Foreclosures Edition*. He is also a contributing author to *Collier on Bankruptcy* and the *Collier Bankruptcy Practice Guide*. Mr. Rao serves as a member of the federal Judicial Conference Advisory Committee on Bankruptcy Rules, appointed by Chief Justice John Roberts in 2006. He is a Fellow of the American College of Bankruptcy, secretary for the National Association of Consumer Bankruptcy Attorneys, and former board member for the American Bankruptcy Institute. Before coming to NCLC, Mr. Rao served as a managing attorney of Rhode Island Legal Services and headed the program's Consumer Unit. His practice included a broad range of cases dealing with consumer, bankruptcy and utility issues, requiring representation of low-income clients before federal, state and bankruptcy courts, and before administrative agencies. Mr. Rao is a graduate of Boston University and received his J.D. in 1982 from the University of California (Hastings).

