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CREDIT CARDS AND BANKRUPTCY: OPPORTUNITIES FOR REFORM

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CREDIT CARDS AND BANKRUPTCY: OPPORTUNITIES FOR REFORM

THURSDAY, DECEMBER 4, 2008

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 2:09 p.m., in the William C. Gaige Hall Auditorium, Rhode Island College, Providence, Rhode Island, Hon. Sheldon Whitehouse, presiding.

Present: Senator Whitehouse.

OPENING STATEMENT OF HON. SHELDON WHITEHOUSE, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator WHITEHOUSE. The hearing will come to order.

Before we begin, I would like to thank Rhode Island College for this official field hearing of the United States Senate Judiciary Committee. I would also like to welcome and thank the students who have joined us for today's events. Young people are most likely to start signing up for credit cards in their college years, so this topic has particular significance to them.

As I have traveled around our State and talked with Rhode Islanders, I have so often heard concerns about out-of-control credit card rates and fees. With each passing year, two things seem to happen: one, the credit card companies get cleverer; and, two, the consumer gets the result. What was a one-page credit agreement just two decades ago is now a 20-page, booby-trap-filled, small-print legal document. Hidden behind the legalese in these documents are snares that lenders have set for consumers, including in some cases the right to raise interest rates for any reason, or in some cases no reason at all. With things economically as bad as they are today, those problems hit home harder. Rhode Island's unemployment rate is 9.3 percent, tied with Michigan, as the Nation's highest.

Times are tough in our Ocean State, and the people who are unemployed or who are underemployed still have living expenses—rent, mortgage, food, clothes, tuition, medicine. With winter approaching, you can add to that heating oil, higher electricity bills, and, of course, holiday gifts for friends and family. All too often, families make these ends meet with a credit card and watch the balance go up and up and up.

About three-quarters of U.S. households have at least one credit card, and 58 percent of those carry a balance. As of 2006, which is the last year that we have got information for, the average credit card balance was almost $8,500. Given what has happened to the

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economy between 2006 and now, you can bet that average balance is well above $8,500 now. And, unfortunately, the practice of the credit card industry is to kick consumers when they are down.

An $8,500 balance at a fair rate paid on time each month might be a manageable debt load for an average family over time. But if that same family falls behind, a 10-percent interest rate can morph into 30 percent or 40 percent or more, making full repayment virtually impossible. A payment that is 1-day late results in an average penalty fee of $28, even though the cost to the credit card company is negligible.

And as the banks feel economic pressure, things gets worse. Citibank had promised that it wouldn't increase credit card rates without cause, but earlier this month it reversed its promise, citing the need to make up for revenues lost in the mortgage market and elsewhere. The practices of the credit card industry are unfair. I think they are also unsustainable, and I believe these practices could lead to further financial collapse unless Congress acts.

There are several things we can could do in Congress. Senator Chris Dodd of Connecticut, our neighbor, has the Credit Card Accountability, Responsibility, and Disclosure Act, which I have cosponsored. This would outlaw some of the most egregious credit card practices, including so-called universal default, where if you default on a different obligation this credit card punishes you for that other default; and then, of course, those "rate increases at any time for any reason" provisions.

I have also cosponsored Senator Dick Durbin of Illinois' Protecting Consumers from Unreasonable Credit Rates Act, which would set a national interest rate cap of, if you can believe it, 36 percent, inclusive of fees. Think for a minute about a world in which Congress has to consider capping interest rates at 36 percent.

I would be remiss if I did not also mention Senator Durbin's Helping Families Save Their Homes in Bankruptcy Act, a critical bill that will help stop people losing their homes to foreclosure. This bill would correct an anomaly in the bankruptcy law whereby a first primary residential home mortgage is not allowed to be adjusted in bankruptcy to have the principal reduced, unlike essentially every other loan agreement that exists. It is unique that way. I hope the 111th Congress will pass this change in January and President-elect Obama will then sign it into law.

In addition to the bills I have mentioned, I also plan to introduce legislation to restore to individual States the ability to protect their own citizens from out-of-State lenders. As Professor Lawless will explain in his testimony, a Supreme Court case a generation ago, in what appeared to be a technical matter, stripped States of their historic rights to enforce such protections.

I am a member of the Judiciary Committee. This is a Judiciary Committee field hearing. The Judiciary Committee has jurisdiction over the bankruptcy system, so this hearing is focusing on using bankruptcy law to protect those who fall prey to abusive credit card interest rates, with particular reference to the Consumer Credit Fairness Act, which I am proud to say Senator Durbin, our Deputy Majority Leader in the Senate, joined me in introducing this past summer. It would amend the Bankruptcy Code to disfavor abusive lenders and thereby encourage reasonable interest rates.

Under the Consumer Credit Fairness Act, claims stemming from credit card agreements with interest rates above a cap of 15 percent above the Treasury yield, which is currently 4.4 percent, would move to the tail end of a bankruptcy proceeding, would get paid last, do not get paid unless everybody else gets paid. In the vast majority of cases, as a result, these lenders would recover nothing at all if their customers entered bankruptcy.

I hope that this will work on three levels: it will protect the consumer in bankruptcy by improving their status; it will protect the consumers short of bankruptcy by giving them additional negotiating leverage with the credit card companies; and it will send a message back up into the credit card industry that these abusive interest rates are no longer a successful business model.

Additionally, my bill would waive the so-called means test from the banking industry-sponsored 2005 so-called bankruptcy reforms, which created a costly and burdensome process that bankruptcy filers must undergo to be eligible to discharge their debts, and it prevents some filers from receiving a discharge at all.

I would now like to introduce our distinguished panel of witnesses. We are fortunate they are able to be with us this afternoon to share their expertise in these matters.

First is Professor Robert Lawless of the University of Illinois College of Law. He is a nationally renowned expert on bankruptcy and consumer law issues. In addition to testifying before our Committee on recent Supreme Court cases this past June, Professor Lawless has published articles in numerous academic publications and has been featured on CNN and CNBC. He has the privilege of teaching at the University of Illinois College of Law, his alma mater.

Professor John Chung, from our own Roger Williams University School of Law across the bay in Bristol, is an expert in bankruptcy law. Prior to beginning his teaching career, Professor Chung worked on the United Nations Compensation Commission, which was formed to process claims and award compensation for losses resulting from Iraq's invasion and occupation of Kuwait in 1990. Professor Chung is a graduate of Washington University and the Harvard Law School.

The Honorable Judge A. Thomas Small has served on the Bankruptcy Court of the Eastern District of North Carolina since 1982 and has twice held the role of chief judge on that court. Judge Small is familiar with banks, having worked in the industry for 13 years prior to joining the bench. He is a graduate of Duke University and the Wake Forest University School of Law. Judge Small is here today in his capacity as a member of the National Bankruptcy Conference, the Nation's premier organization of bankruptcy experts. His written testimony today represents the official position of the National Bankruptcy Conference.

Finally, John Rao of Newport, Rhode Island, is an attorney with the National Consumer Law Center, who focuses on consumer credit and bankruptcy issues. The National Consumer Law Center performs research and trains attorneys who serve low-income consumers. Mr. Rao was appointed by Chief Justice Roberts to serve on the Federal Judicial Conference Advisory Committee on Bankruptcy Rules. Mr. Rao earned his degree from Boston University and the University of California Hastings College of Law.

I would also like to take a brief moment to thank Professor Elizabeth Warren of Harvard Law School for her tireless efforts in fighting for consumer protections and her help in drafting my legislation. Professor Warren was originally scheduled to be a witness here today, but she had to cancel because she was appointed to chair the Congressional Oversight Panel of the United States Treasury Bailout Program. You read of her work in Tuesday's New York Times, and I wish her the best as she oversees and audits the bailout program.

I would also take a moment to recognize a State Senator who is present, Rhode Island State Senator Juan Pichardo, and the very distinguished bankruptcy judge of Rhode Island, Judge Votolato. Nice to have you with us, Your Honor. Haven't seen you in a while.

Following the witnesses' opening statements, which I ask them to limit to 7 minutes, I will ask questions on their testimony; and after we have concluded the formal hearing, the witnesses have kindly agreed to join me in taking questions from the audience in a general panel. If any of you have a story or an experience you would like to share or a question that we can answer, I hope you will stay around after the hearing concludes to take part in this session.

And now I turn the hearing over to Professor Lawless for his testimony.

One final piece of business. Before everybody begins, may I please ask you to stand and be sworn. Do you affirm that the testimony you are about to give before the Committee will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. Lawless. I do.

Judge Small. I do.

Mr. Chung. I do.

Mr. Rao. I do.

Senator WHITEHOUSE. Thank you all very much. Professor Lawless, please proceed.

STATEMENT OF ROBERT M. LAWLESS, PROFESSOR OF LAW, UNIVERSITY OF ILLINOIS COLLEGE OF LAW

Mr. LAWLESS. Thank you, Senator Whitehouse. Thank you for inviting me to testify today to the Senate Committee on the Judiciary.

It is no longer a lot of work to get people's attention about the explosion of consumer credit. The graph I have put up on the screen shows the growth in consumer credit over the last 50 years. Even after controlling for inflation and population growth in the United States, we owe five times as much as we did 50 years ago on our household debt and almost twice as much as we did just one decade ago.

There has been a huge run-up in the amount of consumer credit outstanding. Over the last 10 years, mortgage debt was substituted for credit card debt. Some of that mortgage debt came in the form of home equity lines of credit. But we now owe more than we do in our national personal income.

One way to look at consumer credit is to compare it to the amount of our National personal income for 1 year. As you can see, from time to time they both rose together, but in the last decade, the amount of consumer credit rose much more dramatically than household income. We now owe more in household debt than our National personal income for one year.

One way to think about that is if we took 1 year and we did not pay for housing, food, utilities, or any of the other necessities of life, it still would not be enough to retire just our National personal household debt.

One of the key events, as you mentioned, Senator, was the 1978 decision in *Marquette National Bank*. The 1978 Supreme Court decision in *Marquette National Bank*, while not alone responsible for the rise in consumer credit, was one of the necessary preconditions to the explosive growth we have seen over the last few decades.

In *Marquette National Bank*, a Nebraska bank wanted to charge 18 percent interest to Minnesota customers, although the State of Minnesota judged that the legal rate should be no higher than 12 percent. The Supreme Court interpreted the National Bank Act of 1864, an act passed in the midst of the chaos of the Civil War to establish a stable national banking system. The Supreme Court interpreted this then 114-year-old statute to let the Nebraska bank export Nebraska law into the State of Minnesota. A law that had been passed as a shield to protect nationally chartered banks from burdensome State regulation, because of the *Marquette National Bank*, decision became a sword that national banks could use to export State law—unprotected State laws into other States whose legislature had made judgments to the contrary.

What happened after *Marquette National Bank* was that banks rushed to States with lax usury regulation or, indeed, in some instances were able to prevail upon some States to repeal their usury statute altogether. The result was an effective national deregulation of interest rates. Banks could relocate in these States with no usury statutes, with no interest rate cap, and then export those rules across the entire country.

Consumer credit took off. The chart that I just showed owes its origins in the 1978 decision of *Marquette National Bank*, and I think one thing that should not be lost on the Committee, Senator, is that this was a decision of the United States Supreme Court interpreting a 114-year-old statute. It was not a decision made by our elected legislative branch. It was not even a decision made by the executive branch. Rather, because of some arcane rules in a 114-year-old statute, we have ended up with a consumer credit system that is completely unregulated as to interest rates.

I want to talk a little bit, though, about high-cost credit in bankruptcy, which is the topic of today's hearing.

Consumer credit is about consumer bankruptcy. As I show in my paper called "The Paradox of Consumer Credit," bankruptcy rates rise with increases in consumer credit. Bankruptcy rates have plummeted in the immediate wake of the 2005 law, but they are back on track to reach 1.1 million bankruptcy filings in the 2008 calendar year.

There is a paradox here. Decreases in the amount of consumer credit lead to a short-term bump in the amount of bankruptcy filings. Just yesterday, I learned that we went over 5,000 bankruptcies per day in the month of November, and that was the first time since 2005. And the reason for the short-term rise we have seen in bankruptcy filings for the past 4 months is likely because of the tightening of consumer credit that we read so much about today in the headlines. People are hurting, and it is beginning to show up in the bankruptcy courts. So let me talk a little bit about what some of our research shows about the people who are showing up in bankruptcy courts.

I am part of a research project called the Consumer Bankruptcy Project, including Professor Elizabeth Warren, and what we do is we go out and we talk to people, we survey people, we interview people, we collect the court records of people who file bankruptcy. The 2007 cohort of the Consumer Bankruptcy Project shows that people of modest means show up in the bankruptcy courts. The myth of bankruptcy being a free ride for high spenders and high-income earners is just that—a myth. The typical person in bankruptcy court shows up with just $27,000 in income and only $53,000 in assets. Against these modest resources, the typical person is $69,800 in debt. Over time, we are also seeing people show up in bankruptcy courts in worse condition but with the same resources.

The Consumer Bankruptcy Project has research cohorts in 1981, 1991, 2001, and 2007, and as you can see from the slide, income levels have been relatively constant throughout this period, yet debt is continuing to increase. People are showing up in bankruptcy court in worse financial shape every time we go back into the field to do our research. The 2005 laws did not sort out the "can pays." We were told in 2005 we were going to get a bankruptcy law that was going to get rid of the high-income people who were abusing the bankruptcy system. If that was true, we would have expected to see income drop after the 2005 bankruptcy law. Instead, it is virtually identical.

The 2005 bankruptcy law did not work. The only thing that has happened is that we have forced people who need the bankruptcy courts out of the system, and the people who are showing up in bankruptcy court now are in worse shape, with higher ratios of debt to their personal household income.

Another way this shows up is in the questions we ask people during the surveys. In both 2001 and 2007, we asked people the same question: How long have you been struggling before you filed bankruptcy? Forty-four percent now say that they financially struggled more than 2 years before they filed bankruptcy. That was the most common response of our survey respondents. More than 2 years before filing bankruptcy most people suffer before they end up in bankruptcy court. Bankruptcy is not a free ride. People do anything to avoid it.

There are a number of fixes that we can have for the consumer bankruptcy system, Senator. The Consumer Credit Fairness Act that you are sponsoring is a very good step in the right direction. As you mentioned, it would subordinate high-cost credit transactions; it would exempt from the means test bankruptcies that were caused by high-cost credit transactions; and the Act would serve as a statement that our Federal bankruptcy courts will not be used as a collection system for abusive and predatory loans.

Another improvement that could be made to the bankruptcy laws is to take steps that would lower the cost of filing. Get the bankruptcy laws off the consumer bankruptcy attorneys' backs so that will lead to lower attorneys' fees and increase accessibility to the bankruptcy courts.

The means test could be repealed in its entirety. The means test, which is meant to shuffle out the "can pay" debtors, we have seen is a failure. It should be repealed in its entirety.

We should eliminate pre-bankruptcy credit counseling. The post-bankruptcy credit counseling is our best chance to change debtors' behavior after filing bankruptcy. The pre-bankruptcy credit counseling is nothing but a hassle and a little bit more cost before people can get to bankruptcy courts. It serves as another hurdle before people can get the relief they need.

And, finally, I recommend that we give bankruptcy judges the power to write down mortgages in Chapter 13, as the Helping Families Save Their Homes in Bankruptcy Act would. This would restore to bankruptcy judges the power they had before the 1993 Supreme Court decision called *Nobelman*. I encourage Congress to pass that law.

Thank you, Senator. Thank you again.

[The prepared statement of Mr. Lawless appears as a submission for the record.]

Senator WHITEHOUSE. Thanks, Professor Lawless. We very much appreciate your being here and having come all this distance.

I would now turn to Hon. Judge Small.

STATEMENT OF HON. A. THOMAS SMALL, U.S. BANKRUPTCY JUDGE, EASTERN DISTRICT OF NORTH CAROLINA, ON BEHALF OF THE NATIONAL BANKRUPTCY CONFERENCE

Judge SMALL. Senator Whitehouse, thank you for giving us, the National Bankruptcy Conference, the opportunity to comment on the Consumer Credit Fairness Act. We strongly support your efforts to address the effects of high-cost consumer credit. Generally, it is not the Conference's policy to support amendments to the Bankruptcy Code that address non-bankruptcy problems such as the problem of high-cost consumer credit. And the Conference prefers and recommends a broader approach to this problem such as a national usury law. But, clearly, high-cost credit does contribute directly to the filing of many bankruptcy cases and has an unfair and adverse effect on other creditors. The Conference, therefore, believes that bankruptcy legislation would be helpful if a broader solution to high-cost consumer credit is not possible.

The bill is a strong start, but we would like to point out a few problems and suggest some ways the bill might be improved. The bill in its current form does not capture some of the more serious credit abuses. Also, the bill, while providing relief for creditors, does not provide relief for consumer debtors and in some circumstances could have detrimental, unintended consequences for some Chapter 13 debtors.

Now, credit often becomes high-cost consumer credit not when the credit is first established but, rather, in the months preceding bankruptcy. As consumers fall behind on their credit cards, their payday loans, their rent-to-own contracts, and other consumer purchases, or exceed their credit limits, they are faced with an avalanche of default rates, late fees, and other additional charges that can cause their balances to skyrocket. Neither the Truth in Lending definition of annual percentage rate nor the bill's reference to the costs and fees incurred at the outset of the loan includes these damaging later-added costs.

And we would suggest that the definition of "high-cost consumer credit" be expanded to cover charges such as late fees and default interest rates so that the definition reflects the actual cost of credit to the borrower. Specifically, we suggest that including the cost of credit imposed within the 6-month period before filing would improve the bill.

A second problem is that by subordinating high-interest claims but not disallowing those claims, the bill helps creditors but not debtors. Subordination solves the problem of high-cost creditors obtaining a disproportionate payment of their claims in bankruptcy, but it really does nothing to help debtors. Subordination reorders which creditors get paid first, but it does not reduce the overall amount that has to be paid.

Instead of subordinating high-cost consumer claims, we recommend that they be disallowed. Non-high-cost creditors would actually receive the same distribution if the claims are disallowed or if they are subordinated. But debtors would be greatly benefitted by disallowance in large-asset Chapter 7 cases, and in full-payout Chapter 13 cases, because the disallowed claims for high-cost consumer credit would be discharged without having to be paid. But I think it is important to keep in mind that in most consumer cases, it really will make no difference to the debtor whether the claims are subordinated or disallowed because most consumer cases, over 90 percent, are no-asset cases in which creditors, whether they are high-interest creditors, low-interest creditors, or no-interest creditors, really receive nothing. The same is true in Chapter 13 where, under means testing, there are more and more zero-payout Chapter 13 plans.

A third problem is that the bill as currently drafted may leave Chapter 13 debtors who do not complete their plans, and consequently have their cases dismissed, with heavier debt loads than when they filed their bankruptcy petitions. This problem would exist whether the high-cost credit claims were subordinated or disallowed. And that is because the effect of subordination or disallowance in a Chapter 13 case is to permit payment of regular claims but not the payment of high-cost consumer credit claims. If the case is dismissed, no debts are discharged, and the high-cost consumer credit claims remain outstanding in greater amounts with the high-interest that accrued while the case was pending. The end result, of course, is that the debtor will owe substantially more than if the high-cost debt had not been subordinated or disallowed.

The solution to that problem is to discharge all fees related to high-cost consumer claims that accrue or are incurred post-petition in a Chapter 13 case in which a plan has been confirmed. This change could be easily implemented by adding a new section to Section 1328.

Finally, although the Conference believes that the current means test is a cumbersome, unnecessarily complex, and ineffective method of determining a debtor's ability to repay unsecured debt, we do not recommend an exclusion from means testing for debtors involved in high-cost consumer credit transactions, as contemplated in the bill. The definition of these transactions is likely to be complex, and the computations necessary to determine an exclusion from means testing based on high-cost consumer credit would turn the already complicated means test forms into an even higher hurdle for individual debtors. Excluding means testing for those debtors in our opinion simply is not worth the considerable trouble it would entail.

In conclusion, the Conference believes that this bill offers a real opportunity to facilitate greater fairness to creditors and debtors and provides a real deterrent to abusive lending practices. The bill is coming along at precisely the right time, and the National Bankruptcy Conference would be happy to provide any other information and to assist in formulating a draft proposals if the Judiciary Committee would find that helpful.

Thank you, Senator.

[The prepared statement of Judge Small appears as a submission for the record.]

Senator WHITEHOUSE. Your Honor, thank you for your testimony, and let me just take this opportunity to thank both you and the National Conference for the clearly careful and thoughtful way that you have examined the bill and for the recommendations you have made. They are all very much in the spirit of what we are trying to accomplish. We look forward to working with you on the technical draftsmanship issues to get these technical aspects of it more clearly right than they were in the first draft, and it is very helpful that you have provided this input.

Judge SMALL. We are glad to assist in any way.

Senator WHITEHOUSE. Professor Chung?

STATEMENT OF JOHN CHUNG, ASSOCIATE PROFESSOR OF LAW, ROGER WILLIAMS UNIVERSITY

Mr. CHUNG. Senator Whitehouse, thank you for inviting me to speak before the Judiciary Committee at this field hearing on this important subject.

I would like to start by presenting a question about compound interest that I ask my students. I do so before this Committee not in the vein of presuming that I am teaching anyone anything new, but with the purpose of directing attention to one of the major problems of high-cost consumer credit. My question is this: At an annual rate of interest of 36 percent, compounded daily—which is how my credit card works—how long does it take for a debt of $1,000 to double? When I ask my students, I usually use 25 percent as an example. I ask this question in every bankruptcy class. My experience has been many students do not know the answer. At the rate of 36 percent, the answer is that the debt doubles in just under 2 years. When I tell my students the answer—and the answer for 25 percent is approximately 3 years—I hear audible gasps of surprise. I then ask, "Where do you see interest rates like 25 percent in the real world?", and they quickly identify their credit cards.

My point is that, from my experience, many law students do not know how quickly debt grows and compounds at rates like 25 percent or 36 percent. I hold my students in the highest regard, and I want to remind the general audience that these are college graduates who had to achieve a certain grade point average and standardized test score to be in my classroom. If some law students are surprised by the answer, I wonder if the typical consumer debtor understands the destructive effect of these interest rates.

And the problem is, of course, that compounded interest of 36 percent does not stop after 2 years. The debt continues to grow. It grows from $1,000 to $2,000 in the first 2 years, then from $2,000 to $4,000 in the next 2 years, then from $4,000 to $8,000, and so on and so on. The growth rate in debt is exponential. Income and asset growth, however, is not—at least for most people.

Once a debtor falls into the trap of exponential debt growth, can such a person ever climb his or her way out? I highly doubt it. Perhaps we are witnessing the 21st century equivalent of the company store where the debtor is just another day older and deeper in debt because he has sold his soul to his credit card issuer.

Given the destructive impact of high-cost consumer credit on borrowers, I believe there is a strong need for the proposed Consumer Credit Fairness Act. The math tells us that once debt starts compounding at rates like 36 percent, the borrower will end up trapped in a vicious cycle of debt spiraling out of control. Laws against usury were designed centuries ago to address this problem, but modern lenders have managed to avoid the application of those laws. The Consumer Credit Fairness Act is needed to restore a more equitable balance between the rights of debtors and creditors. The reference to usury laws is also helpful because it points out that the Act is a measured, sober response to the problem of excessively high interest rates and is based on long-established debtor-creditor principles. The legal history of England and the United States recognized the need to prohibit excessively high interest rates. Blackstone's Commentaries on the Laws of England, printed in 1765, discussed usury laws. I make this point to rebut the anticipated, but weak, argument by lenders that the proposed Act would upset their expectations and constitute a drastic upheaval in the debtor-creditor relationship. The need to address the problem of excessively high interest rates is well established, and the fundamental purpose of the proposed Act stands on firm legal and historical ground.

In addition to restoring more balance to the historical debtor-creditor relationship, I believe that the proposed Act deserves praise because it addresses more contemporary problems—problems created by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In particular, I am referring to the famous—or infamous—means test. The proposed Act's exemption of certain debtors from the means test is a welcome attempt to provide relief to borrowers in need of protection from crushing interest rates.

I would like to make one general observation about the recent changes in consumer bankruptcy law. I think it is highly likely that the next generation of legal historians will see some significance in the fact that the Bankruptcy Code was amended in 2005. 2005 was at or near the peak of the subprime-fueled housing bubble. I understand that the amendments were years in the making, but the fact that the reforms finally passed that year is probably not just coincidence. In the mania of that bubble, anyone could become a multi-millionaire just by buying a house, or two or three. The frenzied spirit of the times questioned the intelligence of anyone who was not making a fortune. It appears there was a sentiment that there was something wrong about someone if he or she was not getting rich. This led to and fed the conclusion that there was something really wrong if someone filed for bankruptcy protection. This line of thinking concluded that in an era of easy and instant riches, the people filing bankruptcy must be doing so to game the system. That meant drastic reform was necessary to stop all those abusers of the system. In hindsight, it appears that the people who needed to be reined in by legislative reform were those who were facilitating and gaming the bubble. It is my hope that the proposed Act represents just one attempt to roll back the 2005 amendments.

The proposed Act deserves support, and this Committee should be applauded for considering this legislation. With regard to the text of the proposed Act, I raise two issues. I raise these issues in the spirit of seeking clarification.

First, the proposed legislation seeks to amend Section 707(b) by adding subparagraph (8), which states that "Paragraph (2) [the means test] shall not apply if the debtor's petition resulted from a high cost consumer credit transaction." The issue I raise is whether 707(b)(8) applies if a debtor files a petition because of high-cost consumer credit and other debt, like a large hospital bill. One could envision a situation where a debtor is injured, incurs hospital bills, and loses income due to an inability to work. Such a debtor would probably turn to his or her credit cards to pay living expenses. The combination of the medical bills and credit card debt would lead to bankruptcy. The creditors would likely raise the issue whether the proposed language applies if the petition results from other debt in addition to high-cost consumer debt.

My second comment is based on my concern with certain language in another provision of the Bankruptcy Code which provides that certain types of consumer debts are nondischargeable. In Section 523(a)(2) there is language that states: "cash advances aggregating more than $825 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 70 days before the order for relief under this title, are presumed to be nondischargeable."

If a debtor has high-cost consumer debt that falls within this language, then subordination of such debt through the proposed amendment of Section 510 will provide little relief because the debt will not be discharged. If the Committee is of the view that there is a need to address the discharge issue, one way to address it would be by amending Section 523 so that debts resulting from high-cost consumer credit transactions are treated as nondischargeable.

Again, I raise these issues as someone who believes in the need for legislation addressing high-cost consumer debt and as someone who supports the proposed Act.

Thank you for the opportunity to present my remarks.

[The prepared statement of Mr. Chung appears as a submission for the record.]

Senator WHITEHOUSE. Thank you, Professor Chung. I appreciate it. Once again, the thoroughness of your inquiry demonstrates the careful look you have taken at it, and I appreciate your advice, and we will work with you to incorporate it.

Attorney Rao?

STATEMENT OF JOHN RAO, ATTORNEY, NATIONAL CONSUMER LAW CENTER

Mr. RAO. Senator Whitehouse, thank you for the opportunity to testify here today and to consider ways to improve our bankruptcy laws to encourage reform of credit card practices. I testify here today on behalf of the low-income clients of the National Consumer Law Center and the National Association of Consumer Bankruptcy Attorneys.

My testimony is based on over 25 years of experience representing consumers and consulting with other attorneys in debt collection, bankruptcy, and foreclosure defense matters, initially as an attorney with Rhode Island Legal Services. In fact, some of that time was before Judge Votolato, who I am so pleased to see here today.

In my experience, 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 for some of these consumers, they often lack savings to cover unexpected expenses. In a recent national survey of indebted low- and middle-income consumers, seven out of ten said that they use credit cards to pay for important things like car repairs, home repairs, medical expenses. Of course, in our current economic situation, even more consumers can be expected to rely on credit cards to get through the difficult times that we see now.

It is also my experience that few consumers borrow money on credit without intending to repay. Their plans to repay, however, easily change, often due to unforeseen circumstances such as adverse events like illness or divorce. Other consumers fall into traps set by credit card companies. Even small setbacks, like using a credit card to pay for some 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. And this is particularly true for some older consumers with diminished incomes after they retire.

There is no question that credit cards provide a great convenience for many consumers. The dangers come from the borrowing features of these cards and can get consumers into deep financial trouble.

Some of these practices of credit card companies such as deceptive marketing, confusing payment allocation rules, retroactive rate increases on existing balances, and universal default, such as you mentioned earlier, Senator Whitehouse, hopefully will be addressed by a pending rulemaking proceeding before Federal agencies and by bills pending in Congress. And while many of those practices alone or in combination can lead a consumer into financial trouble, my focus today will be on the punitive practices of credit card companies once they get into trouble and once they are trying to get out of financial trouble by repaying their debts and avoiding bankruptcy.

Rather than try to help payment troubled consumers with an affordable monthly payment that would reduce the balance owed, card companies do the opposite and jack up interest rates to a penalty rate, usually as soon as the consumer makes a late payment or exceeds the credit limit. These penalty interest rates can be as high as 30 to 40 percent.

Another real contributing factor to this snowballing effect is all of the additional punitive fees like wire transfer fees, cash balance over-limit fees. Rather than assist borrowers who honestly seek to repay their debts, card companies really prefer to extract as much as they can during this period of time just before filing bankruptcy. As Professor Lawless said, in this 2-year period where they are struggling to repay their debts, they are actually being imposed with more fees.

The chief counsel of the Comptroller of the Currency described this business model as, "The focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset." I would like to give you some examples of these that demonstrate this.

One example is a Rhode Island senior who recently passed away, who 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 getting nowhere in paying off the payments, the balances. A review of his card statements confirmed his concern. At some point after he had stopped using his cards, excessive interest rates and other fees absorbed all of his payments and actually were increasing his balance.

For example, his credit card statement in December 2006 showed that he had made a $200 payment in November of that year, 2006. However, an interest charge of $272.87 based on a 32.24-percent 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. You may ask why would anyone pay $200 only to get more than $100 behind. He 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.

One widely publicized case in Ohio was very similar, almost—really even worse. This consumer had a balance of $1,963. She decided that she was not going to use the card anymore, and over the next 6 years paid to her credit card company $3,492 in payments. One might assume that would have paid off her debt completely.

During the 6-year period before her account was sent to collection, not one penny of the $3,492 in payments went to reduce her debt. She was charged during that time $9,056 in interest, late fees, and over-limit fees. Amazingly, after paying almost $3,500 on a $1,963 debt, her balance grew by another $5,564.

There are many other examples of these, especially when claims are filed in bankruptcy, and we have examples of large portions, as much as 50 percent of the claims that are filed in Chapter 13 cases on credit cards, consist of interest, late fees, and over-limit fees.

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 by cashing in on their 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. Therefore, we strongly support the Consumer Credit Fairness Act, and thank you, Senator Whitehouse, for introducing that bill. It is a strong step in the right direction.

Thank you again.

[The prepared statement of Mr. Rao appears as a submission for the record.]

Senator WHITEHOUSE. Thank you very much for your testimony, and thank you also for your work on behalf of consumers who are caught in this—the words that have been used include "trap," "spiral," "snowball." It implies a very dynamic process in which the credit card companies are working pretty actively to keep consumers in—you described it as sort of that 2-year period.

Professor Lawless, before the hearing, you told me about a colleague of yours who used the phrase "sweat box" to describe this. Would you describe for the record that term and how it is used?

Mr. LAWLESS. Sure. That term comes from a law review article in the *University of Illinois Law Review*, ironically enough, called "The Sweat Box of Credit Card Debt," by Professor Ronald Mann, now at Columbia University. And his point is that the credit card companies, as John Rao has just pointed out, no longer use this model of lending and getting paid back. The old "It's a Wonderful Life," of getting repaid and making a little bit of money off the interest, that is gone. That time is gone. That is not the way consumer lenders work anymore.

What was the phrase that was used? We want a perpetual asset—

Mr. RAO. Perpetual earning asset.

Mr. LAWLESS. Asset producing perpetual revenue. And that is the idea, the sweat box idea, is that when the credit card companies make the most money off of borrowers is when people are not in good enough shape that they are paying on time, but they are not in bad enough shape that they can file bankruptcy or need to file bankruptcy. Credit card companies make the most money when consumers are in the sweat box, as Professor Mann put it, when they are piling up the huge interest rates, piling up the big penalty fees. The longer the credit card companies can keep people in that sweat box, the more money the credit card companies are going to make. And the effect of the 2005 bankruptcy law—you know, we talk about the means test—but the real big effect of the 2005 bankruptcy law was to raise the cost of filing in terms of money and time and hassle. When you raise the cost of something, people are going to use less of it. And what happened is that we pushed back the amount of time before someone is going to be desperate enough to file bankruptcy and keeping people in that sweat box longer. That has been the effect of the 2005 bankruptcy law. That is what I think the consumer credit industry wanted, and from our data, I think that is what they got.

Senator WHITEHOUSE. Judge Small, one of the points that you made in your testimony was that pre-bankruptcy credit counseling, which was something that the banks argued for in the 2005 so-called reform, has not been effective and has the effect of delaying the day when they can get into the court and seek your protection.

In the context of this revenue-producing asset model, in the context of this sweat box model, would it be fair to look at the mandatory pre-bankruptcy, pre-filing credit counseling as a time period that extends this sweat box in which they work the consumer?

Judge SMALL. I think so. I think credit counseling has proven not to work at all. It is just another obstacle that debtors face to getting into bankruptcy. And I think the more obstacles you can take away, the better.

Senator WHITEHOUSE. The card companies are not unsophisticated about this stuff. They must realize that credit counseling prefiling does not work, so presumably there is another motive. Does it make sense to you that keeping consumers in this so-called sweat box is that motive?

Judge SMALL. It could very well be. It certainly has that effect. You might ask, why would a debtor stay in this sweat box for a couple years when he has got all this debt that he really cannot pay, even at the regular interest rates? We see debtors all the time that have $30,000, $40,000, $50,000, $60,000 in credit card debt. Sometimes that is what their annual income is. At 18 percent, how are they ever going to pay that off? Well, probably they cannot.

But people believe in paying their debts. There is a misperception that debtors are abusing the bankruptcy system. Well, I can tell you that the debtors that come into my court do not want to be there. That is the last place they want to be. They want to stay away from bankruptcy. They want to pay their debts. And most of them are walking the tightrope. They are making the minimum payments. They are doing the best they can to meet their obligations and not get into bankruptcy. Then they get behind on one payment, and under a universal default, then their interest rate goes from 18 percent up to 29 percent, and that can be on all their credit cards. Then at that point I think they realize that there really is no way I am going to be able to make it, and they go into bankruptcy.

There is another factor here, too. These people are proceeding in good faith, trying to pay their debts, and once they get hit with all these late charges, the universal default fees, they feel like, well, gee, why am I doing this? Why am I killing myself trying to pay all this debt when they are not helping me at all, in fact, they are working against me?

Senator WHITEHOUSE. One of the explanations for some of this, Professor Chung, that I have heard—and I would love to hear your comment on this observation—is that different credit card companies are aggressive to different degrees, but that the worst of them, the ones who are most aggressive, the one who comes up with the most clever and diabolical traps, have the effect of increasing their revenues and, in effect, driving the market, and that other credit card companies that may not have wished to take that step now feel obliged to match the market and follow along, and that there is sort of a bad-actor, follow-the-leader phenomenon that is taking place. And the further observation that was made to me about that is that there is no logical end in sight to that unless somebody steps in and does something. I would like your observation on that.

Mr. CHUNG. Well, I agree with that last observation completely. Until someone intervenes—and by "someone," I mean the Federal Government—I do not see an end to these sorts of practices.

I wish I knew how the inner mechanisms of the credit card industry worked, but I am sure it works along the line of viewing these loans as this perpetual revenue-generating asset. That is the only way it makes sense in terms of why they do these things. And as Professor Lawless mentioned, it has really gotten past the point of—the lenders do not even seem to care if the principal is ever paid back.

I think what is motivating lenders is that as long as some sort of payment is being made on the loan, then it does not have to go into a special category as a delinquent asset or become some sort of special asset. As long as they can keep it on their books as a good asset, that is all they care about.

My guess is that they do not care about the amount of the indebtedness. All they care is that there is some sort of partial debt service going on. And, in fact, in terms of the examples of Mr. Rao, you have this increasing debt load, but instead of it being a problem loan—I think a common-sense line of thinking would say, Well, isn't that a problem if the debt just keeps going up? Well, yes, if you ask the average person common sense-wise, yes, that seems like a problem. But from the credit card issuer's perspective, that is not a problem. That is exactly what they want because that is where the money is.

And so I think the credit card issuers are following each other's business models, and really the maximization of profit lies in the people who are unable to pay down the debt but are able to service part of it. And they do not really care how long, or if ever, that principal is outstanding because they can always record these as being good assets on the books with income coming in every year, and to the extent that the principal grows, that means our assets are growing. So, actually, from their balance sheet perspective, it is actually a good thing if the credit card debt keeps going up.

So if that is how the business model works, then, you have some really, I think, unwise incentives—I mean in terms of societal incentives—regarding debt growth. The government should step in to unwind or to undo these really unwise incentives because no private participant will do on its own.

Senator WHITEHOUSE. If you go back to Mrs. Owens, she is a good illustration of that. She owed $1,963. Over 6 years she paid back $3,492. In your testimony, you calculated that that would be payment of 100 percent of principal and an effective interest rate of 21 percent, which is a pretty good return to a lender. And yet at the end of that exchange, the effect was not that Mrs. Owens had paid off her debt and the lender had made 21 percent and everybody was happy. It was that she still owed—what was it?—$5,564 that I suppose the credit card company, in addition to having made 21 percent, could then write off as a loss on that account.

Mr. RAO. That is right. As Professor Mann has shown, that model works so well because they have essentially recovered all of—all of the charges that Ms. Owens made have been paid. So everything essentially after a certain point is just absolutely pure profit, especially when you look—and what he looks at in his work, which is very interesting, is that the cost of borrowing, especially over the past 5 years or so, has been really quite low. For the credit card companies, they are borrowing their own at 3 percent, and they are now charging 30 percent to the borrower. So, clearly, this is a model that works very well for them in terms of the profit.

Judge Small also mentioned that a lot of times when consumers file, they may have $30,000 or $40,000 in credit card debt. And when you look actually at how much—and to a lot of the individuals in the audience who may think, Well, how could it get that large? Why could someone have $30,000, $40,000 in unsecured credit card debt? In many of these cases, if you look at each card, it may be that there is only about $4,000 or $5,000 of actual charges on them. These debts grow quickly at these interest rates.

In the case of the Rhode Islander that I mentioned, when he stopped paying his credit card, it then had increased to about $9,000. Within a year and a half, it had been transferred to several debt collection companies and had grown to $15,000. Just in a year and a half, it had grown that much. So, you know, when you look at a bill and you say, well, that is $14,000, it may only be $5,000 of actual card use.

Senator WHITEHOUSE. You are in this market in Rhode Island day to day. As the economic stress that we are experiencing nationally has really focused hard in Rhode Island and made it so hard on families, what are you seeing in your practice? Are you seeing a change?

Mr. RAO. Well, actually, my practice is more actually now based on where I work in Boston, but I do work with the attorneys at the Rhode Island Legal Services. Certainly the biggest problem right now is the home foreclosure problem. That is the thing especially what they are dealing with quite a bit. But there is a relationship between the credit card problem and the foreclosure. There are some very important reasons why we are in the foreclosure problem that we have. But for some consumers, they have gotten into this problem because they have used their house as a way to deal with credit card debt. They have gotten home equity. They have borrowed on their house to pay off credit card debt over the past 10 years. And, in fact, even after they get these mortgages, sometimes they will be paying—they will be diverting payments that should be going to the mortgage to pay credit card companies at these 30-percent interest rates and falling into default on mortgages.

So all of this credit problem picture is very much tied together, and it is hard to look at one without the effect on the other.

Senator WHITEHOUSE. And it appears to be expanding.

Mr. RAO. Absolutely.

Senator WHITEHOUSE. Walk me through the steps that take somebody up to one of these exorbitant interest rates. You get the solicitation in the mail. It says, I do not know, 10.9-percent APR in great big print. It has got a 20-page contract behind it. You sign it, you send it off, and before you know it, you are paying an effective interest rate of 30, 40, 50 percent once you put in late penalties and fees.

How does that happen? Walk me through a sort of generic scenario of Joe Debtor getting clobbered.

Mr. RAO. Well, sadly, Senator, I wish it were a long story in which there was a lot to really describe. But again, sadly, the scenario is something that can be described very quickly. In that situation—you know, for a lot of consumers who actually do not use a credit card for convenience purposes and pay off their balances, there is not a problem. But for the consumers who are struggling, a lot of the lower- and middle-income families, they will get that credit card. It might be fine for 2 or 3 months, 6 months if they are lucky. But as soon as there is a late payment, that is it. All it can simply take is being late with a payment. And even there, there are so many tricks in terms of late payment.

We were involved in a case where we were able to show that the credit card company had had a policy in which your—let's say your payment was due on the 17th of the month, and you posted it in a way so that it would be received on the 17th of the month. It would be late if it was received by the credit company at 11 a.m. that day because their cutoff time was 10 a.m. that day. Now, most consumers would think I have until the end of the business day, 5 o'clock or 6 o'clock, to make that payment. Well, those are the kinds of practices that get consumers to get behind, and all it takes is that one late payment, and now they are being jacked up to a much higher interest rate.

So I wish there was a much longer description of what it takes to get into trouble, but sometimes it really does not take much at all.

Senator WHITEHOUSE. Is there a list of these various tricks and traps that you have assembled? I mean, that is pretty inventive, to have a 10 o'clock in the morning cutoff. They have probably figured out when the mail is delivered, which is at 11:00.

Mr. RAO. Actually, I have to say that the Federal Reserve Board and the other agencies are trying to crack down on those very policies. And, in fact, there is a proceeding pending right now which will try to prevent that kind of thing from happening. But, yes, there are many of those kinds of examples of different types of—

Senator WHITEHOUSE. Professor Lawless, you wanted to add something?

Mr. LAWLESS. Yes. You started off with a 10-percent APR. That is not what the solicitation is going to say. It is going to say zero-percent APR. These traps and tricks are trade secrets in the consumer credit industry. Elizabeth Warren, a name we have invoked a few times here today, has estimated that the consumer credit industry does 400 to 500 experiments a year to try to figure out what makes people sign up for these credit solicitations. The consumer credit industry knows better than you or I do how we are going to use our credit cards. So the deck is already stacked before that envelope is opened.

Senator WHITEHOUSE. How much disclosure is there of all of that?

Mr. LAWLESS. Well, there is the same disclosure we all see, which is a couple of pages of very fine print that you need a magnifying glass to read and that even a law professor often cannot understand. I have tried to read these credit agreements myself, and it takes me 45 minutes to try to decipher it. The idea that disclosure is going to solve the problem is a myth, is a fairy tale. It is not going to—

Senator WHITEHOUSE. But I mean in terms of their research and their product, that is all proprietary and they will not let any of that—

Mr. LAWLESS. Oh, the disclosure of that, those are all trade secrets. We have no idea. One thing you mentioned earlier—it would be a great help to university researchers and people trying to study this. We had a conference at the University of Illinois last May. We assembled scholars from all over the world that work on consumer debt, and this was where this point was made about 400 to 500 experiments being run by the consumer credit companies. We were celebrating people that had run a couple experiments a year. We need more disclosure from the consumer credit industry about what they are charging to people, how much people are paying.

We do not know, for example, right now what the average rate is that is being paid on credit cards. Data is reported to the Federal Reserve, but only in the aggregate. So we do not know these slices of the very high default rates. And one of the things I would encourage Congress to take a look at is forcing more disclosure on the consumer credit industry so people like myself, people at universities, people who are not paid by either side, can look at these data and try to make sound policy prescriptions.

Senator WHITEHOUSE. Let me ask one last question, and then open it to any public comment or question that we may have, and that is, there has been—we have kicked around in Washington a certain amount the idea of a Financial Product Safety Commission along the lines of the Consumer Product Safety Commission. If a toaster is defective, the Consumer Product Safety Commission will have something to say about it, and yet these highly complex, as you have described, financial instruments that even lawyers have trouble understanding are marketed across the country to people who have no real way to look into it themselves. And there really does not seem to be an institution that can attach a warning to it and say, look, here is the real deal, this is not approved, this is not legitimate, this is a dangerous product, you will face these consequences if you enter into it.

Do you think that sort of an idea makes sense?

Mr. LAWLESS. Well, I guess I have to respectfully disagree on that one. I see the same problems that have led the proponents of that sort of commission to propose it, but for the same reasons that disclosure is not working now, I think sticking a warning label on something is not going to work. Instead, I think ideas like your Consumer Credit Fairness Act that gets in and gets at the root of the problem, which is the price that is being put on the consumer credit, would be a better way to go. I think substantive regulation that cracks down on these practices in the long run will be more effective than another regulatory commission that is going to be battling the consumer credit industry. It is going to be a stacked deck if you are going to have a government agency against one of the Nation's largest industries that is one of the Nation's best industries at tricking consumers into signing up for their high-cost products.

Senator WHITEHOUSE. Well, with that, let me call the official part of the hearing to a conclusion. I thank the witnesses for their testimony and remind them that the hearing remains technically open for another week if anybody wishes to supplement their testimony in any way.

We are now officially adjourned.

[Whereupon, at 3:14 p.m., the Committee was adjourned.]

[The submissions for the record follows.]

SUBMISSIONS FOR THE RECORD

Written Testimony of Professor John Chung

Roger Williams University School of Law

"Credit Cards and Bankruptcy: Opportunities for Reform"

Hearing of the United States Senate Committee on the Judiciary at its Field Hearing

December 4, 2008

Senator Whitehouse, thank you for inviting me to speak before the Judiciary Committee at this field hearing on this important subject.

I would like to start by presenting a question about compound interest that I ask my students. I do so before this committee, not in the vein of presuming that I am teaching something new, but with the purpose of directing attention to one of the major problems of high cost consumer credit. My question is: At an annual rate of interest of 36%, compounded daily (which is how my credit card works), how long does it take for a debt of $1000 to double? When I ask my students, I usually use 25% as the example. I ask this question in every bankruptcy class. My experience has been many students do not know the answer. At the rate of 36%, the answer is just under 2 years. When I tell my students the answer (the answer for 25% is approximately 3 years), I hear audible gasps of surprise. I then ask, "Where do see interest rates like 25% in the real world?", and they quickly identify their credit cards.

My point is that, from my experience, many of my law students do not know how quickly debt grows and compounds at rates like 25% or 36%. These are college graduates who had to achieve a certain grade point average and standardized test score to be in my classroom. If some of my students are surprised by the answer, I wonder if the typical consumer debtor understands the destructive effect of these interest rates.

And the problem is, of course, that compounded interest of 36% does not stop after two years. The debt continues to grow. It grows from $1000 to $2000 in the first two years, then from $2000 to $4000 in the next two years, then from $4000 to $8000, and so on and so on. The growth in debt is exponential. Income and asset growth, however, is not (at least for most people).

Once a debtor falls into the trap of exponential debt growth, can such a person ever climb his or her way out? I highly doubt it. Perhaps we are witnessing the 21st century equivalent of the company store where the debtor is just another day older and deeper in debt because he has sold his soul to his credit card issuer.

Given the destructive impact of high cost consumer credit on borrowers, I believe there is a strong need for the proposed Consumer Credit Fairness Act. The math tells us that once debt starts compounding at rates like 36%, the borrower will end up trapped in a vicious cycle of debt spiraling out of control. Laws against usury were designed centuries ago to address this problem, but modern lenders have managed to avoid the application of those laws. The Consumer Credit Fairness Act is needed to restore a more equitable balance between the rights of debtors and creditors. The reference to usury laws is also helpful because it points out that the Act is a measured, sober response to the problem of excessively high interest rates and is based on long-established debtor-creditor principles. The legal history of England and the United States recognized the need to prohibit excessively high interests rates. Blackstone's Commentaries on the Law of England, printed in 1765, discussed usury laws. I make this point to rebut the anticipated, but weak, argument by lenders that the proposed Act would upset their expectations and constitute a drastic upheaval in the debtor-creditor relationship. The need to address the problem of excessively high interest rates is well-established, and the fundamental purpose of the proposed Act stands on firm legal and historical ground.

In addition to restoring more balance to the historical debtor-creditor relationship, I believe that the proposed Act deserves praise because it addresses more contemporary problems – problems created by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In particular, I am referring to the famous (or infamous) means test. The proposed Act's exemption of certain debtors from the means test is a welcome attempt to provide relief to borrowers in need of protection from crushing interest rates.

I would like to make one general observation about the recent changes in consumer bankruptcy law. I think it is highly likely that the next generation of legal historians will see some significance in the fact that the Bankruptcy Code was amended in 2005. 2005 was at or near the peak of the subprime-fueled housing bubble. I understand that the amendments were years in the making, but the fact that the reforms finally passed that year is probably not just coincidence. In the mania of that bubble, anyone could become a multi-millionaire just by buying a house, or two or three. The frenzied spirit of the times questioned the intelligence of anyone who wasn't making a fortune. It appears there was a sentiment that there was something wrong about someone if he or she wasn't getting rich. This led to and fed the conclusion that there was something really wrong if someone filed for bankruptcy protection. This line of thinking concluded that in an era of easy and instant riches, the people filing bankruptcy must be doing so to game the system. That meant drastic reform was necessary to stop all those abusers of the system. In hindsight, it appears that the people who needed to be reined in by legislative reform were those who were facilitating and gaming the bubble. It is my hope that the proposed Act represents just one attempt to roll back the 2005 amendments.

The proposed Act deserves support, and this Committee should be applauded for considering this legislation. With regard to the text of the proposed Act, I raise two issues. I raise these issues in the spirit of seeking clarification.

First, the proposed legislation seeks to amend Section 707(b) by adding subparagraph (8), which reads: Paragraph (2) [the means test] shall not apply if the debtor's petition resulted from a high cost consumer credit transaction." The issue I raise is whether 707(b)(8) applies if a debtor files a petition because of high cost consumer credit and other debt, like a large hospital bill. One could envision a situation where a debtor is injured, incurs hospital bills, and loses income due to an inability to work. Such a debtor would probably turn to his or her credit cards to pay living expenses. The combination of the medical bills and credit card debt would lead to bankruptcy. The creditors would likely raise the issue whether the proposed language applies if the petition results from other debt in addition to high cost consumer debt.

My second comment is based on my concern with certain language in Section 523(a)(2), which provides that certain types of consumer debts are nondischargeable. For example, 523(a)(2)(C)(i)(II) provides: "cash advances aggregating more than $825 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 70 days before the order for relief under this title, are presumed to be nondischargeable."

If a debtor has high cost consumer debt that falls within this language, then subordination of such debt through the proposed amendment of Section 510 will provide little relief because the debt will not be discharged.

If the Committee is of the view that there is a need to address the discharge issue, one way to address it would be by amending Section 523(a)(2)(C) so that debts resulting from high cost consumer credit transactions are treated as nondischargeable.

Again, I raise these issues as someone who believes in the need for legislation addressing high cost consumer debt, and as someone who supports the proposed Act. Thank you for the opportunity to present my remarks.

WRITTEN TESTIMONY OF PROFESSOR ROBERT M. LAWLESS
University of Illinois College of Law

"Credit Cards and Bankruptcy: Opportunities for Reform"
Hearing of the United States Senate Committee on the Judiciary
December 4, 2008

Americans owe over $13.1 trillion on their home mortgages, credit cards, automobile loans, and all other forms of household debt.[1] We owe more in household debt than our annual national personal income, a circumstance that was not true as recently as 2003.[2] Even if we devoted all of the national income for one year to repayment and did not spend any money on housing, food, utilities, health care or any of the other necessities of life, it would not be sufficient to retire our household debt. We have gone from a society where most consumer borrowing was episodic and for special purchases to a society where many families have to use credit to pay for ordinary household expenses and are permanently indebted. Over half of American families with a credit card now carry a monthly credit balance.[3] The attitudinal change toward consumer debt is one of the greatest cultural shifts of the past thirty years. We now found ourselves in an economic crisis that has its origins in this orgy of consumer borrowing, and before it is over this crisis may exceed the upheaval and privations of the Great Depression.

We have come to this situation largely because of historical accident. Laws passed for one purpose in an earlier time were used for different purposes in a later era. The story begins when, amidst the chaos of the Civil War, Congress passed the National Bank Act of 1864 to create a banking system that would stabilize the nation's finances.[4] A banking system that the federal government controlled was controversial, and there was concern that states might use

[1] See Figure 1 in the Appendix. These data are taken from Federal Reserve Statistical Release G.19, *Consumer Credit* (available at http://www.federalreserve.gov/releases/g19/) and Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* (available at http://www.federalreserve.gov/releases/z1/).

[2] See Figure 2 in the Appendix.

[3] Brian Bucks, 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, Feb. 2006, at A1, A31.

[4] National Bank Act of 1864, ch. 106, 13 Stat. 99.

their legislative powers to defeat the national banking system before it got established. Consequently, Congress included a number of provisions to protect the new national banks, and among these provisions was a rule that prevented states from applying lower interest rate caps to the nationally chartered banks than the states could apply to their locally chartered state banks.[5] Interstate lending was of limited concern to the 1864 Congress. The information technology of the age necessarily limited the extent to which a national bank might lend to customers in distant markets.

Over one hundred years later, changes in information technology and the development of a credit reporting system had made it possible for lenders to assess the creditworthiness of faraway borrowers. At the same time, borrowers could find faraway lenders as sophisticated marketing and advertising techniques made it possible for consumers to learn of lenders in another state. States had effective usury laws that limited the interest rates that lenders could charge consumers, but that was about to change. In a 1978 case called *Marquette National Bank v. First of Omaha Service Corp.*,[6] the Supreme Court turned what Congress intended to be a protective shield into a sword, ruling that the National Bank Act allowed national banks to export the most lenient usury laws any other state of the Union.

The immediate consequence of *Marquette National Bank* was that the Nebraska bank that litigated the case could charge Minnesota consumers an 18% interest rate although Minnesota law capped interest rates at 12%. Because of the Supreme Court's interpretation of the 114-year old National Bank Act, the Nebraska bank could charge the interest rate allowed by Nebraska to any citizen of the United States even if that person lived in a state whose legislature had made a judgment to give its citizens more protection from usurious interest rates. Perhaps only in retrospect the next step seemed inevitable and made *Marquette National Bank* one of the more obscure Supreme Court decisions to have some of the most far-reaching consequence. After the Court's decision, consumer lenders rushed to locate national banks in states that traditionally had no usury law or that had recently repealed their usury statutes at the behest of the

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[5] *Id.* § 30, 13 Stat. at 108. The provision remains codified at 12 U.S.C. § 85.

[6] 439 U.S. 299 (1978). For a discussion of the *Marquette National Bank* decision, see Robert M. Lawless, "Marquette National Bank v. First of Omaha Service Corp." in *Encyclopedia of the Supreme Court of the United States* (David Tanenhaus ed., 2008).

consumer lending industry. By relocating to states with no usury statute, lenders could charge whatever interest rate they could extract from consumers across the country. Just in the past month, Citigroup announced it would raise interest rates to its credit card customers to try to make up for lost profits from the economic crisis.[7] Thus, we went from a system where each state could have its own usury law to a system where federal law preempted the choices states had made about the maximum rates of interest that their citizens should pay. In this instance, however, federal preemption meant no regulation as consumer lenders raced to the bottom to find the states that would let them charge whatever interest rate they pleased.

After *Marquette National Bank*, consumer lending took off. With lenders now able to charge exorbitant rates of interest, even marginal borrowers could find lenders willing to extend massive amounts of consumer credit. Consumer lending euphemistically was said to be "democratized," a term that was intended to reflect the fact that persons who previously had been cut off from credit were now able to borrow. By using the term "democratization," the implication was that the huge increases in consumer debt were a positive social development, but that claim ignored the costs that came with these huge increases.[8] Bankruptcy filings increased sharply.[9] The costs of consumer credit rose as lenders discovered that consumer interest rates were unresponsive to changes in changes in supply and demand. In 1996, the Supreme Court extended *Marquette National Bank* to credit card fees, meaning lenders now could extract huge penalty fees from consumers. [10] Late fees for credit cards have more than doubled since 1996 and averaged $35 as of two years ago.[11] Fee income has become a major profit center for the credit card industry. The traditional lending model where consumer lenders made their money by being repaid and earning a profit off the interest is now outdated.

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[7] *See* Eric Dash, *Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult Environment,'* N.Y. Times, Nov. 14, 2008, at B1.

[8] An overview of the rise in consumer lending in the 1980s can be found at David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 Am. Bankr. L.J. 311, 332-42 (1999).

[9] Over the long-term, bankruptcy filings rise hand-in-hand with increases in consumer credit. *See* Robert M. Lawless, *The Paradox of Consumer Credit*, 2007 U. Ill. L. Rev. 347 (2007). See also Figure 3 in the Appendix.

[10] Smiley v. Citibank (South Dakota), 517 U.S. 735 (1996).

[11] *See* Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, at 18 (September 2006).

The best customers are those who pay late, incurring high penalty default rates of interest and late fees.

Our task today is to focus on how Congress can shape the bankruptcy law to be more responsive to consumers who find themselves awash in debt and especially high-cost credit card debt, but we need to remember how we came to have a consumer financial system where over 1 million households each year can find themselves needing bankruptcy relief. These consumers have been caught up in a huge regulatory shift that allowed consumer lending under very permissive rules. The entire picture is complex, and changes to the bankruptcy laws should only be part of the solution. Letting the states again experiment with interest-rate regulation would be one step in the right direction. Although some may quibble with the wisdom of usury laws despite their long tradition, it is difficult to quibble with allowing states to make that judgment for themselves and harness the power of the states to experiment with different regulatory regimes so the best governmental initiatives may be passed along to everyone.

Before turning specifically to changes in the bankruptcy law that can help consumers, it is important to establish a few facts about what we see from consumers who have to turn to the bankruptcy system to escape crushing debt loads. My colleagues and I recently published a study describing what happened to consumers after the 2005 changes to the bankruptcy law. Our study was the first to be able to use a national random sample of bankruptcy filers from 2007.[12] Bankrupt debtors represent a slice of middle-class America, with modest incomes and modest homes. The typical debtor shows up in bankruptcy court with $27,000 in annual income[13] and assets of $53,000.[14] Against, these modest resources, the typical debtor has almost $34,000 in unsecured debt[15] such as credit card, utility, and medical bills and another $35,000 in secured debt.[16] The typical homeowner in bankruptcy has a house worth $110,000 with a

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[12] *See* Robert M. Lawless, et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 Am. Bankr. L.J. 349, 353-56 & App. I (2008) (describing methodology).
[13] *Id.* at 404. Because a few outliers skew the average values for the measurements of assets, debt, and income, I am following the convention of the article by reporting median values as the typical filer.
[14] *Id.* at 365. Figure 4 in the Appendix shows these figures.
[15] *Id.* at 367, Fig. 7.
[16] *Id.* at 404.

mortgage of $102,000.[17] Considering everyone in our study, the typical household in bankruptcy had debt equal to 3.3 years of income.[18]

The 2007 study followed research cohorts in 1981, 1991, and 2001, which allowed us to compare bankruptcy filers in these different years. We find relatively flat incomes among bankruptcy filers over this time but increasing levels of debt. Each time we have done our study, we have found consumers showing up in bankruptcy court in worse shape than the previous study.[19] The 2005 changes to the bankruptcy laws were sold to Congress as a way to separate the "can pay" debtors from the "can't pay" debtors. Despite the opinions of experts who did not see widespread abuse in the bankruptcy system, we were told that the 2005 changes to the bankruptcy law would force debtors to pay as much as they could to their creditors. Instead of forcing "can pays" out of the bankruptcy courts (or at least into chapter 13 for partial debt repayment) and leaving only those with more modest incomes eligible for bankruptcy, the data show no change in the income levels of bankruptcy filers after the 2005 amendments. These findings thus cast doubt on the suggestion that those purged from the bankruptcy courts were high-income deadbeats. Instead, they appear to have been ordinary American families in serious financial distress. The real effect of the 2005 bankruptcy law was to increase the cost and hassle of filing bankruptcy, extending the amount of time that consumers would suffer before seeking bankruptcy relief. We find evidence of that delay in our study as well, with over 44% of our debtors telling us that they seriously struggled for more than two years before filing bankruptcy, where only 32% of the debtors made such a statement before the 2005 laws.[20]

This hearing appropriately focuses on how we can improve our bankruptcy laws to help households deal with high-cost credit card debt. When you improve the bankruptcy laws, you help improve the lives of those struggling with credit card debt. The typical bankruptcy filer in our study had unsecured debt—most of which was credit card debt—in an amount that was greater than the household's annual income. Bankruptcy is not an easy solution and requires a

[17] *Id.* at 365.
[18] *Id.* at 371-72.
[19] See Figure 5 in the Appendix.
[20] *Id.* at 381. See also Figure 6 in the Appendix.

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household to turn over all of its assets or income in repaying creditors. When bankruptcy is necessary, it is an escape valve from the endless cycle of astronomically high interest rates, penalty fees, and ever-increasing balances that credit cards give their customers. The most profitable credit card customer is a customer who is having trouble making payments and thereby paying the highest interest rates and fees. The longer credit card companies can keep customers paying these high interest rates and fees, the more profit they make. That is why credit card companies oppose changes to the bankruptcy law,[21] but changes should be made. These changes should include:

- The Consumer Credit Fairness Act,[22] introduced by Senators Whitehouse and Durbin, would subordinate high-cost credit transactions to the claims of all other creditors in bankruptcy. This bill would help to address the problem of abusive loans made possible by the permissive regulatory scheme created by *Marquette National Bank*. In its current form, the bill would subordinate any loan on which the interest and fees were more than 15% plus the rate on 30-year Treasury obligations (up to a maximum of 36%). It also would serve the very helpful purpose of excusing from the section 707(b) means test a consumer's bankruptcy that was caused by a high-cost credit transaction. Although consumer lenders do not expect large recoveries in bankruptcy and would continue to charge exorbitant interest rates despite this proposal, the bill would help many consumers through its exemption of the means test and would be a powerful statement that the federal bankruptcy courts would not be used as a vehicle for consumer lenders to collect exorbitant rates off the backs of the middle class.
- Perhaps the most helpful thing Congress could do is to take measures that would lower the costs of filing bankruptcy. Making it easier for attorneys to provide legal services to consumer debtors will drive down attorneys' fees and increase accessibility to the bankruptcy courts. Congress should remove unnecessary responsibilities from bankruptcy attorneys to vouch for the minute details in their clients' lengthy financial

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[21] Ronald J. Mann, *Consumer Bankruptcy and Credit in the Wake of the 2005 Act: Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. Ill. L. Rev. 375
[22] S. 3259, 110th Cong., 2d Sess.

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statements (Bankr. Code § 521). Bankruptcy attorneys should not be treated as suspicious "Debt Relief Agencies" as Bankruptcy Code §§ 526-528 now do. Provisions such as Bankruptcy Code § 521 should be rewritten so they do not create unnecessary paperwork for debtors to collect and attorneys to organize and file. Also, Congress should return the filing fees for chapter 7 and chapter 13 to their pre-2005 levels. The $299 it takes to file chapter 7 and $274 for chapter 13 are large amounts of money to someone who is at the end of their financial rope. Even a modest remittance to $235 for chapter 7 and $217 for chapter 13 would be a big help.

- Proposals to make specific exceptions to the means test, like the Consumer Credit Fairness Act does for consumer bankruptcies caused by high-cost consumer credit will provide meaningful relief to some consumers. Congress could go much further and repeal in its entirety the means test of Bankruptcy Code § 707(b), which determines eligibility for chapter 7. As our study shows, the means test has failed in its screening function because there were not large numbers of "can pay" debtors in the system. The means test is only another hoop that debtors and their attorneys must jump through before getting to bankruptcy court. The related use of the means test calculations to determine the amount of payments in chapter 13 (Bankr. Code § 1325(b)) also should be dropped. Both sections 707(b) and 1325(b) are generating litigation as bankruptcy courts try to apply the rigid and arcane minutiae of each provision to the many experiences of real-life human beings. This litigation only further drives up the cost of bankruptcy filings. Congress should restore the discretion of bankruptcy judges to decide when chapter 7 cases are abusive and when a chapter 13 debtor needs to contribute a greater portion of their income toward debt repayment.
- The prebankruptcy consumer credit counseling required by section 109 should be repealed. The prebankruptcy credit counseling has turned out to be what it was destined to be—a mere formality. In the vast majority of cases, the prebankruptcy credit counseling is nothing more than a telephone call or Internet session that just adds hassle and another $50 cost before filing bankruptcy. The postbankruptcy course in personal

financial management that Bankruptcy Code § 727 put in place has much better promise to change debtors' behavior after a bankruptcy filing.

- The Helping Families Save Their Homes in Bankruptcy Act[23] would help debtors use chapter 13 as a tool to keep their homes by restoring to bankruptcy judges the power to put a mortgage lender in the same position it would be after a foreclosure but leaving the debtor in the home. Under this legislation, a bankruptcy judge could order a debtor to pay off a home mortgage in an amount equal to the value of the residence. The debtor benefits because to the extent the value of the mortgage exceeded the value of the house, the debt would be forgiven. The mortgage lender benefits by getting a promise to pay equal to the value of the house, which is what it would have had if it sold the house outside of bankruptcy. This simple change would bust the power of mortgage lenders to extort payments from debtors and benefit consumers widely by giving borrowers increased bargaining leverage to renegotiate mortgages before they got to bankruptcy court. In chapter 13, bankruptcy judges already have these powers with respect to mortgages on vacation homes or secured loans on a debtor's boat. This bill would only extend that power to mortgage loans on a debtor's house.
- Congress should amend chapter 13 to ensure that small business owners do not have to give up their business to fund a chapter 13 plan. To clear up any ambiguity, Congress should make clear in section 1325 that the business expenses of a small business owner are deductible expenses in determining the amount of "disposable income" a debtor has to devote to a chapter 13 plan. If the means test is not repealed, similar amendments should be made to section 707(b) to ensure that a small-business owner only has to consider his or her net income (and not gross revenues) in determining eligibility for chapter 7.

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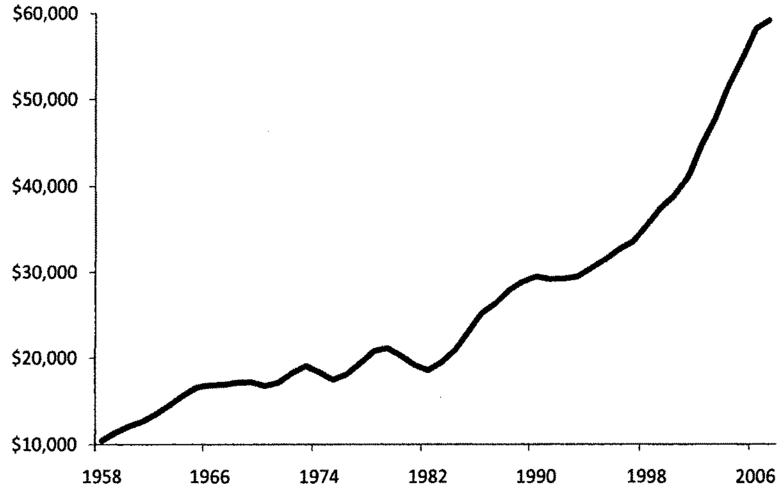
[23] S. 2136, 110th Cong., 2d Sess.

APPENDIX

Household Debt per Adult, 1958-2007

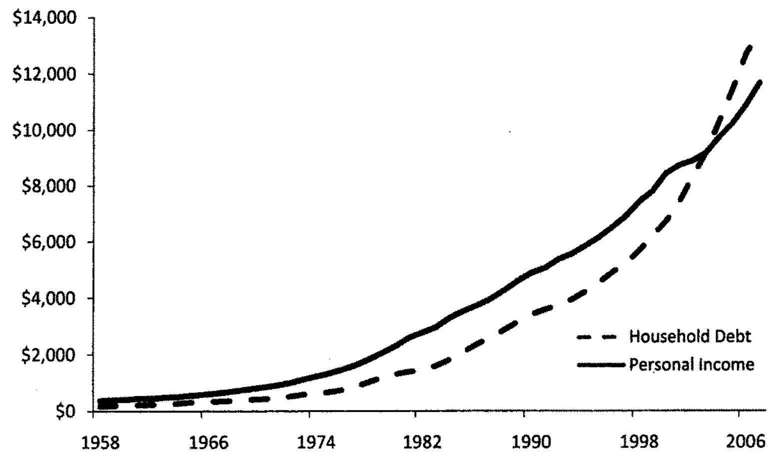
Figure 1

Figure 1 shows the amount of household debt per adult citizen (defined as all adults over the age of 18) of the United States beginning in 1958 and through the year 2007. Household debt is defined as the amount of home mortgage debt from Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* plus the amount of consumer credit from Federal Reserve Statistical Release G.19, *Consumer Credit*. Data are inflation adjusted using the Consumer Price Index—All Urban Consumers (CPI-U) from the Bureau of Economic Analysis. Population data are from the U.S. Census Bureau.



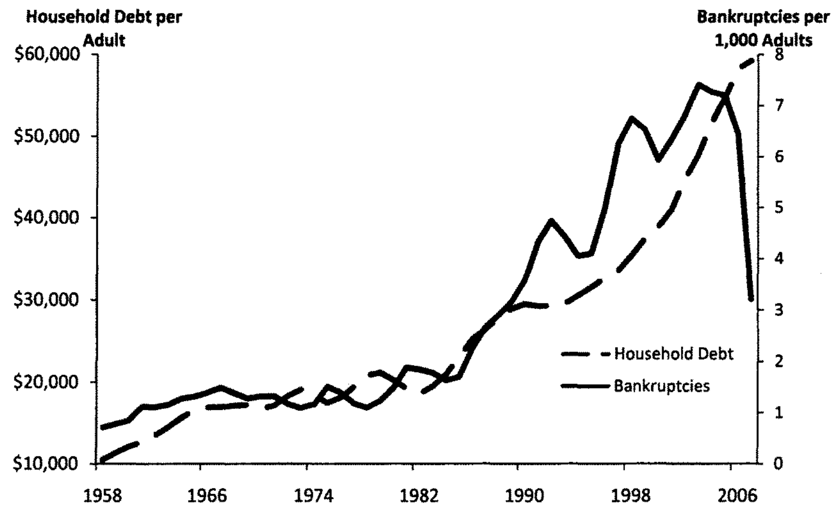
Household Debt Relative to Personal Income (in billions), 1958-2007
Figure 2

Figure 2 compares the outstanding household debt to national personal income. Household debt is defined as in Figure 1 as the amount of home mortgage debt from Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* plus the amount of consumer credit from Federal Reserve Statistical Release G.19, *Consumer Credit*. National personal income is from the Bureau of Economic Analysis. Both amounts are presented in nominal dollars (i.e., not inflation adjusted) and represent total amounts in billions.



Household Debt and Bankruptcy Filing Rates, 1958-2007
Figure 3

Figure 3 compares the outstanding household debt per adult to bankruptcy filing rates per 1,000 adults. Household debt is defined as in Figure 1 as the amount of home mortgage debt from Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* plus the amount of consumer credit from Federal Reserve Statistical Release G.19, *Consumer Credit*. The household debt data are inflation adjusted using the Consumer Price Index—All Urban Consumers (CPI-U) from the Bureau of Economic Analysis. The bankruptcy filing data represent nonbusiness filings from the Administrative Office of U.S. Courts for the 12-month period ending June 30 of each year. Population data are from the U.S. Census Bureau.



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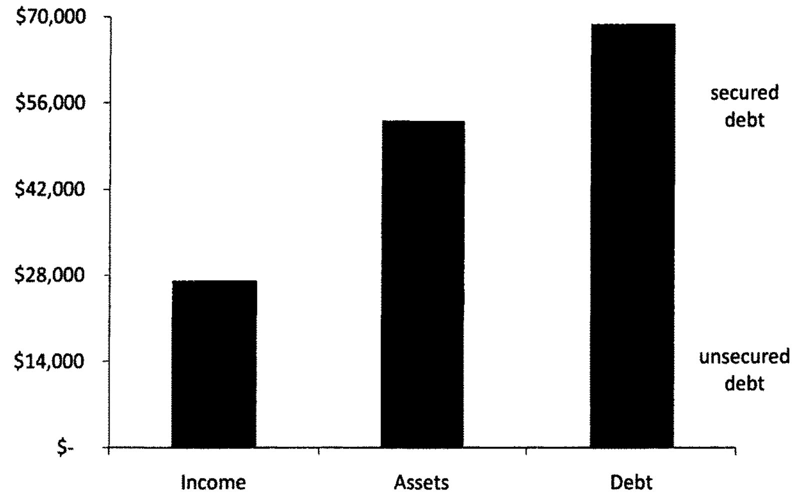
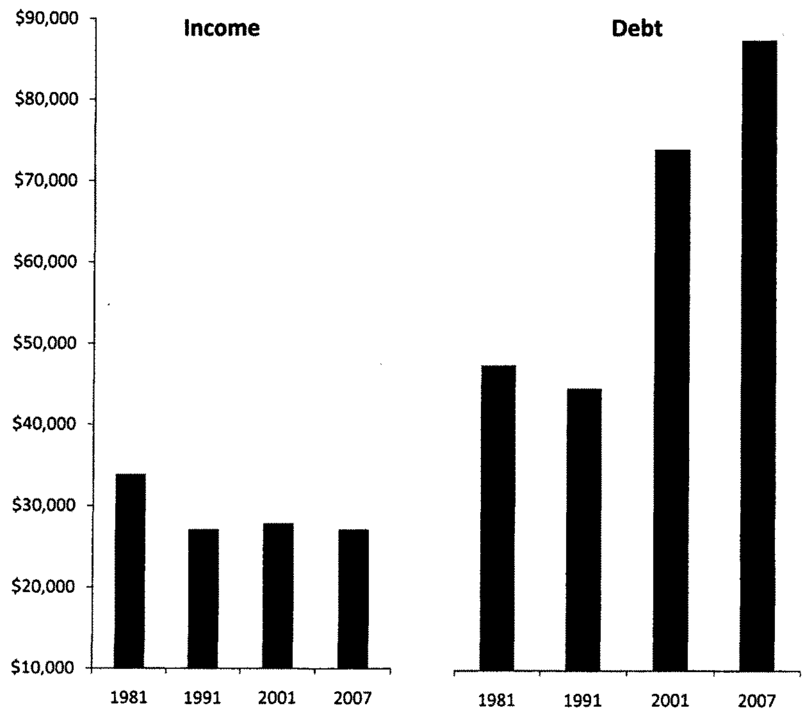
Median Financial Characteristics of Bankruptcy Filers, 2007
Figure 4

Figure 4 shows the median amount of income, assets, and debt data as reported on the bankruptcy schedules from a national random sample of bankruptcy filers in the Consumer Bankruptcy Project .



Changing Income and Debt of Median Bankruptcy Filer
Figure 5

Figure 5 shows the changing amounts of income and debt across the four cohorts of the Consumer Bankruptcy Project. Income and debt data are from the bankruptcy schedules of bankruptcy filers.



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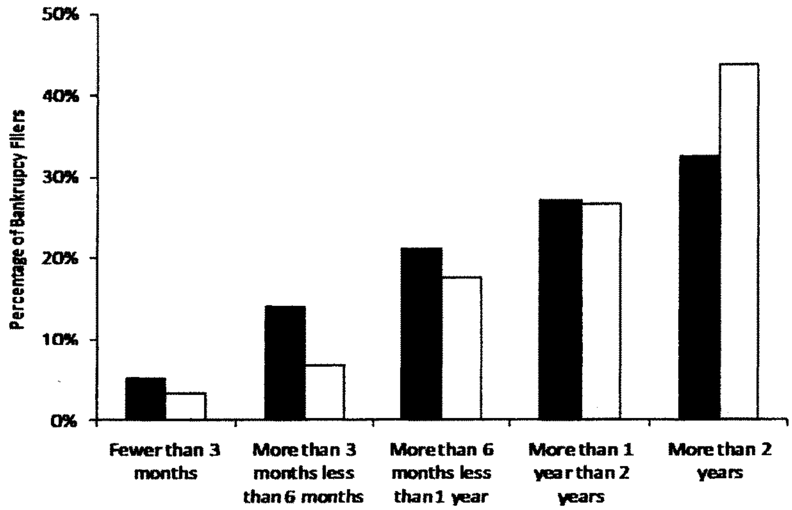
Amount of Time Struggling Before Bankruptcy
Figure 6

Figure 6 shows the responses from the 2001 and 2007 cohorts of the Consumer Bankruptcy Project on how long each respondent estimated they struggled with financial problems before filing bankruptcy. The black bar shows the 2001 responses, and the light-colored bar shows the 2007 responses.



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TESTIMONY OF JOHN RAO

ATTORNEY,
NATIONAL CONSUMER LAW CENTER

DIRECTOR,
NATIONAL ASSOCIATION OF CONSUMER
BANKRUPTCY ATTORNEYS

BEFORE THE SENATE JUDICIARY COMMITTEE

"Credit Cards and Bankruptcy: Opportunities for Reform"

December 4, 2008

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.

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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.

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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.

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- 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.

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[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.

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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
Total	$ 9,056.28

[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.

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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]

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[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

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[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.

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Testimony of

A. Thomas Small[1]

on behalf of the

National Bankruptcy Conference

before the

Senate Judiciary Committee

110th Congress, 2nd Session

for Hearings on

Credit Cards and Bankruptcy: Opportunities for Reform

December 4, 2008

The National Bankruptcy Conference is grateful for the opportunity to participate in this hearing and to comment on S. 3259. The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and on any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees.

The NBC strongly supports the efforts of the bill's co-sponsors to address the effects of high cost credit on consumers generally and in bankruptcy cases. High cost credit is often the cause of a debtor's bankruptcy. High cost credit permits lending to borrowers whose ability to repay is tenuous. While such lending may provide benefits to some borrowers and to the

[1] United States Bankruptcy Judge, Eastern District of North Carolina.

economy, its effect on many borrowers and, as we are currently seeing, on the economy generally and therefore on all Americans, can be devastating, resulting in bankruptcy for some borrowers who would have maintained financial health but for the additional, aggressively marketed credit. In addition, the credit's high cost itself may push some borrowers who are able to handle ordinary credit over the brink of solvency and into bankruptcy. High cost creditors should not be rewarded in bankruptcy to the detriment of debtors and their other creditors. In bankruptcy, high cost credit can be unfair to other creditors, who share pro rata in bankruptcy distributions, to have their recoveries diminished when the claims of high cost lenders are inflated by exorbitant interest rates, fees and charges. Bankruptcy courts are courts of equity, and there is a point at which excessive fees and charges should not be permitted.

As an important matter of bankruptcy policy, the NBC believes that legislation that addresses a broad financial problem such as that addressed by S. 3259 should apply generally, not only in bankruptcy. It is an important bankruptcy policy that entitlements created and regulated under nonbankruptcy law not be materially upset and reordered in bankruptcy, unless there is a specific bankruptcy purpose for doing so. The Bankruptcy Code largely reflects that division of regulatory purposes. Disparate treatment in bankruptcy can create an independent incentive to file a bankruptcy petition when a debtor might otherwise be able to work out problems outside of bankruptcy. It can also, in some circumstances, create unfairness to the creditor whose rights are being modified only in bankruptcy. And, though Bankruptcy Code provisions such as the ones proposed by S. 3259 can have an important prophylactic effect in regulating the extension of credit, which itself is an important regulatory goal, the NBC believes that such goals are usually better and more precisely achieved through more direct regulation of the problem behavior or business practices. The Bankruptcy Code largely reflects such a division of legislative responsibility and does not attempt to regulate conduct through Bankruptcy Code provisions. Therefore, the NBC recommends that the Committee consider revising the bill to address the problem of high cost credit directly, by legislation aimed directly at the interest rates, fees, charges and practices of the high cost lenders. Non-bankruptcy alternatives, such as a national usury law (or permitting states to extraterritorially enforce state usury laws), are possible ways to deal with problems caused by high cost consumer credit. We believe that it would be the preferable way to approach the problem that this bill has so correctly identified.

That said, we recognize that the Bankruptcy Code does occasionally provide treatment of claims in bankruptcy that differs from their non-bankruptcy law entitlements. Several examples readily come to mind, including subordination of securities law claims (§ 510(b)), equitable subordination based on a creditor's inequitable conduct (§ 510(c)), limitation on real property lease and employment contract breach damage claims (§ 502(b)(6), (7)), and provision of recourse claims to nonrecourse secured lenders in chapter 11 cases (§. 1111(b)). Each of these provisions is designed to further a specific bankruptcy policy, to balance creditors' rights among themselves and as against the debtor in bankruptcy. More recently, Congress added § 502(k) to the Bankruptcy Code to permit partial disallowance of a creditor's claim if the creditor refused to negotiate a reasonable repayment plan for a consumer debtor. This provision, differing in some measure from the others referenced above, was designed to influence creditor behavior before bankruptcy in a manner intended to reduce consumer debtors' need for bankruptcy relief. Thus, Congress has not uniformly adhered to the policy of respecting nonbankruptcy rights in bankruptcy, where there is an important bankruptcy reason for departing from that policy. Because of the pervasiveness of the high cost credit problem, the NBC does not believe that this is the right issue on which to depart from that policy. We believe that the problem should be addressed more broadly.

However, because high cost credit contributes directly to the filing of many bankruptcies and has an adverse effect on other creditors in bankruptcy, the NBC believes that bankruptcy legislation to deal with high cost credit may be appropriate. If the Committee determines that the problem of high cost credit should be addressed only in the Bankruptcy Code, for the prophylactic effect it may have and for the protection in bankruptcy of the debtor and other creditors, the NBC would support S. 3259 in general. We believe that the bill as currently drafted could be improved to provide the desired protection. Although the NBC supports the goals of S. 3259, we are concerned that the bill in its current form does not address some of the more serious credit abuses, does not provide relief for consumer debtors, and could have detrimental consequences for some chapter 13 debtors. The first problem is that the definition of high cost consumer credit is not broad enough to include excessive fees charged after the initiation of the credit transaction, which in many cases are the "straw" that breaks the debtor's back. A second problem is that by only subordinating high cost credit claims but not disallowing them, the bill may help other creditors but not the debtor. Third, the bill as currently drafted may leave chapter 13 debtors who are unable to complete their repayment plans, often because of circumstances beyond their control (and, consequently, have their cases dismissed) with heavier debt loads than when they filed their petitions. Finally, the NBC, although generally opposed to “means testing” in its present form, believes that for the reasons stated below, debtors with high interest credit should not be excluded from that test.

Definition of High Cost Consumer Credit

In bankruptcy, creditors are usually paid a pro rata share of what is available for distribution. That means that high cost credit tends to reduce the payout for other legitimate creditors by inflating the amount due the high cost creditor with high interest rates, add-on fees and costs. S. 3259 strives to identify such creditors and to deal with them appropriately.

The bill proposes to borrow from the Truth in Lending Act, and so to build on the large body of case law that has developed under that well-known consumer protection provision. The NBC generally agrees with that approach.

The bill proposes to borrow the TILA-defined concept of "annual percentage rate," then to add in costs and fees incurred when the loan is first taken out, and finally to effectively "cap" that cost of credit at the lesser of one of two numbers. The first number is derived from a calculation that adds 15 percent to the yield on 30-year U.S. Treasury securities. The second number is 36 percent. Thus, automatically, credit that costs more than either of these two numbers is "high cost consumer credit." The Conference agrees that a 36% rate should be included in the definition of high cost consumer credit. The alternative cap in today's market would be around 20%, which is close to the interest rate on many ordinary credit cards. The Conference notes this for the Committee's consideration and has a concern about a rate that is too low but does not take a position with respect what percentage rate below 36%, if any, would be an appropriate level.

In addition, the NBC believes that a more comprehensive definition of high cost consumer credit is in order. Credit often *becomes* high cost consumer credit in the months preceding bankruptcy. As consumers fall behind on their credit cards, their payday loans, their rent-to-own contracts, and other consumer purchases, a blizzard of default interest rates, late fees, and other additional charges can cause the balance of the loan to suddenly skyrocket.

Unfortunately, neither the TILA definition of APR nor the bill's reference to the costs and fees incurred at the *outset* of the loan includes these later- added costs.

We appreciate the sponsors' desire to have a clear, workable standard for defining high cost consumer credit. The statutory standard, however, must work on the real life facts to which it will be applied. The financial complexities involved should not be disregarded. We recommend that the definition of high cost consumer credit be expanded to cover charges such as late fees, over limit fees and default interest rates, so that it reflects the actual cost of credit to the borrower. Specifically, we suggest that including the actual cost of credit imposed within the six-month period before bankruptcy would improve the bill.

We are happy to offer our assistance to you and your staff in drafting appropriate language.

<u>Subordination or Disallowance of Claims?</u>

Once high cost consumer credit transactions are defined, the question becomes, how should they be treated in bankruptcy? The most effective treatment will provide both relief for debtors and fair treatment for other creditors.

As presently drafted, S. 3259 deals with high cost consumer credit by subordinating it to other debts and by avoiding any lien that secures it, with the lien retained for the benefit of the debtor's estate. This treatment would certainly prevent high cost creditors from obtaining a disproportionate payment of their claims in bankruptcy. In Chapter 7, all of the debtor's nonexempt property—including any property that was collateral for the high cost consumer credit—would be distributed to creditors, with the high cost consumer debt paid only after the other creditors had been paid in full. There would be a similar result in Chapter 13, since under the "best interest test" of 11 U.S.C. § 1325(a)(4), a debtor's plan must provide all creditors with at least as great a payment as they would have received in Chapter 7. Indeed, because of the requirement for subordination, Chapter 13 plans might well be required to pay all other debts in full before the high cost credit claims were given any payment. In this way, creditors with more reasonable finance charges would certainly be benefitted.

However, subordination does nothing to help the debtor and, in some circumstances in Chapter 13 cases, it could make the debtor's situation worse. Subordination does not help debtors because it does not reduce the total amount of the claims that must be paid. Although rare, there are Chapter 7 cases in which the debtor's estate is sufficient to pay all claims in full. In such cases, the high cost consumer debt, though subordinated, would also have to be paid in full. In other Chapter 7 cases, the debtor would surrender whatever nonexempt assets were available, and subordination would only affect the manner in which the assets were distributed. In Chapter 13, some plans provide for full payment of all creditors, and under these plans, the high cost credit claims would receive the same full payment as under current law. And in plans paying less than the full amount of the outstanding debts, subordination would not reduce the amount that the debtor was required to pay into the plan; it would affect only the distribution to creditors. Thus, the bill treats the high cost credit claims differently with respect to the debtor's creditors, but makes no corresponding adjustment for the debtor.

The NBC recommends that, instead of subordinating high cost consumer claims, they should be disallowed. Creditors, whose claims would not be diluted by the disallowed high cost credit, would receive the same distribution as if the high cost consumer credit were subordinated. In no asset chapter 7 cases and in chapter 13 cases with modest dividends, debtors would not be benefitted by disallowance. However, in large asset chapter 7 cases and full payout chapter 13 cases debtors would be significantly benefitted because the disallowed high cost credit claims would be discharged without payment. Additionally, since the severe consequence of disallowance to lenders who extend high cost consumer credit is more onerous than that of subordination it will be more likely to discourage abusive lending practices.

Liens are already avoided to the extent that a claim is not allowed, pursuant to 11 U.S.C. § 506(d), as interpreted by the Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410, 415-16 (1992). So, if the bill provides for disallowance rather than subordination, there will be no need for a new provision avoiding any lien on high cost consumer credit transactions.

We recognize that disallowance is less consistent with the important bankruptcy policy of respecting non-bankruptcy rights in bankruptcy cases. Subordination contravenes that policy less. However, if the Committee determines that this issue should be addressed in bankruptcy, rather than more broadly, then we have concluded that disallowance is more effective to protect debtors than subordination.

In addition, beyond the failure of subordination to help debtors, there is a significant harm in any Chapter 13 case that is dismissed before the debtor obtains a discharge, as may happen where a debtor, often due to circumstances beyond his or her control, is unable to complete a three- to five-year repayment plan. This problem also exists whether a claim for high cost credit is subordi6anted or disallowed. In these dismissed cases, the claims that existed at the time the case was filed will remain subject to collection, with interest as allowed under nonbankruptcy law, reduced only by the payments that were actually made during the case. If a lien was avoided, it is reinstated under 11 U.S.C. § 349(b). The effect of subordination or disallowance in any Chapter 13 case is to pay other debts in greater amounts than the high cost consumer credit claims. So in a dismissed Chapter 13 case, the high cost consumer credit claims remain outstanding in greater amounts, with the high interest that accrued while the case was pending. The end result? The debtor will owe substantially more than if the high cost debt had not been subordinated.

The solution to this problem is to discharge all interest, fees and charges related to high cost consumer claims that accrue or are incurred post-petition in a chapter 13 case in which a plan has been confirmed. This could be easily implemented by adding a new subsection to § 1328.

Exclusion from Means Testing

Finally, the NBC believes that the current means test, set out at 11 U.S.C. § 707(b)(2)(A), is inadequate. This test has been tried, and it fails to do its job. It is a cumbersome, unnecessarily complex, and ineffective method of determining a debtor's ability to repay unsecured debt.

However, even with the faults of the means test, the NBC does not recommend an exclusion from means testing for debtors involved in high cost consumer credit transactions, as contemplated in the bill. As noted earlier, the definition of such transactions is likely to be complex, and the computations necessary to determine an exclusion from means testing based on high cost consumer credit would make the already complicated means test forms even more daunting to individual debtors. See, for example, the recent addition of Line 1C to Official Form 22A, implementing the exclusion from means testing provided for in the National Guard and Reservists Debt Relief Act of 2008, Pub. L. No. 110-438.

Conclusion

Once again, thank you for inviting the National Bankruptcy Conference to testify in this important hearing. Senate Bill 3259 offers the opportunity to do real good and to facilitate greater fairness in debtors' repayment of their debts. The Conference believes its suggestions would improve the efficacy of the bill, and we would be happy to provide any additional information on these points if the Committee would find it helpful. The Conference also would be pleased to formulate drafting proposals and assist in technical matters.

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