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**Testimony Of**  
**Travis B. Plunkett,**  
**Legislative Director,**  
**Consumer Federation of America**  
**and**  
**Edmund Mierzwinski,**  
**Consumer Program Director,**  
**U.S. Public Interest Research Group**

**On Behalf Of**  
**ACORN, Americans For Fairness In Lending, The Consumer Federation Of America,**  
**Center For Responsible Lending, Consumer Action, Consumers Union, Demos,**  
**National Association of Consumer Advocates,**  
**Consumer Law Center (On Behalf Of Its Low-Income Clients),**  
**National Training and Information Center, Public Citizen and U.S. PIRG**

**Before The**  
**Subcommittee On Financial Institutions And Consumer Credit**  
**of the United States House of Representatives**  
**Committee on Financial Services**  
**The Honorable Luis Gutierrez, Chair**

**Legislative Hearing Regarding**  
**H.R. 627, The Credit Cardholders' Bill Of Rights Of 2009 And**  
**H.R. 1456, The Consumer Overdraft Protection Fair Practices Act Of 2009**  
**March 19, 2009**

## Testimony of Twelve Consumer and Community Groups On HR 627 and HR 1456 Before the Subcommittee on Financial Institutions and Consumer Credit by Travis Plunkett of the Consumer Federation of America and Edmund Mierzwinski of U.S. PIRG

Chairman Gutierrez, Ranking Member Hensarling and members of the Subcommittee, we appreciate the opportunity to offer our comments on two crucial consumer protection bills introduced by Representative Maloney: the Credit Cardholders' Bill of Rights (H.R. 627) and the Consumer Overdraft Protection Fair Practices Act (H.R. 1456). We are testifying today on behalf of ACORN,<sup>1</sup> Americans For Fairness In Lending,<sup>2</sup> Consumer Federation of America (CFA),<sup>3</sup> the Center for Responsible Lending,<sup>4</sup> Consumer Action,<sup>5</sup> Consumers Union, the publisher of Consumer Reports,<sup>6</sup> Demos,<sup>7</sup> the National Association of Consumer Advocates,<sup>8</sup> the National Consumer Law Center,<sup>9</sup> on behalf of its low-income clients, Demos, the National

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<sup>1</sup> ACORN is the nation's largest grassroots community organization of low- and moderate-income people with over 400,000 member families organized into more than 1,200 neighborhood chapters in 110 cities across the country.

<sup>2</sup> **Americans for Fairness in Lending (AFFIL)** works to reform the lending industry to protect Americans' financial assets. AFFIL works with its national Partner organizations, local ally organizations, and individual members to advocate for reform of the lending industry.

<sup>3</sup> The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

<sup>4</sup> The **Center for Responsible Lending (CRL)** is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, which consists of a credit union and a non-profit loan fund focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to purchase homes. Self-Help has provided over \$5 billion in financing to more than 60,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the United States. Another affiliate, Self-Help Credit Union, offers a full range of retail products, and services over 3,500 checking accounts and approximately 20,000 other deposit accounts, and recently inaugurated a credit card program.

<sup>5</sup> **Consumer Action**, founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC. For more than two decades, Consumer Action has conducted a survey of credit card rates and charges to track trends in the industry and assist consumers in comparing cards.

<sup>6</sup> **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about goods, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

<sup>7</sup> **Demos** is a New York City-based non-partisan public policy research and advocacy organization founded in 2000. A multi-issue national organization, Demos combines research, policy development, and advocacy to influence public debates and catalyze change.

<sup>8</sup> The **National Association of Consumer Advocates, Inc. (NACA)** is a nonprofit 501(c) (3) organization founded in 1994. NACA's mission is to provide legal assistance and education to victims of consumer abuse. NACA, through educational programs and outreach initiatives protects consumers, particularly low income consumers, from fraudulent, abusive and predatory business practices. NACA also trains and mentors a national network of over 1400 attorneys in representing consumers' rights.

<sup>9</sup> The **National Consumer Law Center, Inc. (NCLC)** is a non-profit 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 and regularly updates a series of sixteen

Training and Information Center,<sup>10</sup> Public Citizen<sup>11</sup> and U.S. PIRG.<sup>12</sup> Our written testimony is joint to address the concerns of all the organizations signed on; we will offer oral testimony today commenting on different important aspects of the bills.

#### SUMMARY:

Swift enactment of both of these bills is necessary to protect millions of consumers from unjustified and abusive loan practices that are putting them at financial risk and draining their income at a time of great economic uncertainty.

The **Credit Cardholders Bill of Rights, H.R. 627**, curbs some of the most arbitrary, abusive, and unfair credit card lending practices that trap consumers in a cycle of costly debt, such as sharply escalating “universal default” interest rates that can double some cardholders monthly payments overnight. It passed the House in 2008 on an overwhelming 312-112 vote. Although the Federal Reserve and other regulators agreed that action was needed and later in the year approved similar regulations, the agencies unwisely stayed compliance until July 2010.<sup>13</sup> Just as the economy needs a recovery now, consumers need protection from unfair credit card practices now. HR 627 would take effect just 90 days after passage and should be enacted immediately. In addition, the bill is more urgent than ever because taxpayers are now propping up major national credit card issuers through several enormously expensive government programs. If the government is going to invest in the credit card industry and attempt to spur the extension of credit, it is essential that it ensure that the loans that this industry is offering to Americans are fair and sustainable.<sup>14</sup> The problem, and the solution, enactment of HR 627, are explained in Part I of this testimony.

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practice treatises and annual supplements on consumer credit laws, including Truth In Lending, Cost of Credit, Consumer Banking and Payments Law, Foreclosures, and Consumer Bankruptcy Law and Practice, as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of 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 the all federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the federal agencies on the regulations under these laws.

<sup>10</sup> **National Training and Information Center (NTIC)** is a national organizing, policy, research, and training center for grassroots community organizations dedicated to building power to reclaim our democracy and advance a far-reaching racial and economic justice agenda.

<sup>11</sup> Public Citizen is a national non-profit organization that represents the interests of consumers and the public in matters before state legislatures, the courts, executive branch agencies, and Congress.

<sup>12</sup> The **U.S. Public Interest Research Group** serves as the federation of and federal advocacy office for the state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of their members.

<sup>13</sup> Federal Reserve System, 12 CFR Part 227 [Regulation AA; Docket No. R-1314]; Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 535 [Docket ID. OTS-2008-0027] RIN 1550-AC17; National Credit Union Administration, 12 CFR Part 706, RIN 3133-AD47; Unfair or Deceptive Acts or Practices.

<sup>14</sup> In January, a number of the organizations signed onto this testimony sent Treasury Secretary Geithner a letter urging that any credit card bank receiving government support through the Term Asset Backed Loan Facility (TALF) program be required to comply immediately with the terms of those Federal Reserve rules and to also provide a program to swiftly reinstate fair interest rates on consumers paying penalty interest rates. According to

Similarly, the **Consumer Overdraft Protection Fair Practices Act, HR 1456**, addresses a separate set of largely unregulated unfair tricks and traps that also place a consumer's wallet at risk. Instead of deterring the practice of bouncing checks, as they did for decades, over the last five to ten years, more and more banks have encouraged consumers to bounce checks and other debits, replacing a beneficial back-up system for checking accounts with a system of high-cost, unsolicited overdraft loans that are in effect the banks' version of a usurious payday loan. The costly, and often multiple, fees charged for these overdraft loans drive their customers further into the red. The problem has grown worse as formerly small cash transactions have been substituted by small debit transactions that are approved at point-of-sale even when the bank knows the account shows a negative balance. The problem, and the solution, enactment of HR 1456, are explained in Part II of this testimony.

### **Part I: The Credit Card Problem.**

#### **Why The House Should Enact The Credit Cardholders Bill of Rights (HR 627).**

The Credit Cardholders Bill of Rights (HR 627), as introduced by Representative Maloney and co-sponsored by over 75 others, curbs some of the most arbitrary, abusive, and unfair credit card lending practices that trap consumers in a cycle of costly debt, such as sharply escalating "universal default" interest rates that can double some cardholders monthly payments overnight. These tricks and traps have always been unfair, but now, at a time when consumers can least afford it, these practices produce devastating financial repercussions. Moderate-income families with little flexibility in their budgets are particularly hard hit if they have to pay more in unjustifiable fees and credit card interest. Signs that credit card delinquencies and defaults are rising sharply should be a further warning that these practices have helped make credit card loans unsustainable for many Americans. The meltdown of the subprime mortgage market demonstrates the importance of ending abusive lending practices when warning signs arise. Congress should take steps now to rein in these practices to forestall an even greater economic crisis.

#### **A. CARDHOLDERS ARE SHOWING SERIOUS SIGNS OF ECONOMIC STRESS**

As the economy has worsened and home foreclosures have increased to record levels, consumers are increasingly having serious difficulty paying their credit card bills. One widely watched measure of financial health, the amount of credit card debt paid off by Americans monthly, is now at one of the lowest levels ever recorded.<sup>15</sup> Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or "written off," have been persistently high for most of the last thirteen years and are now approaching the highest levels on record. During the decade between the end of 1995 and the

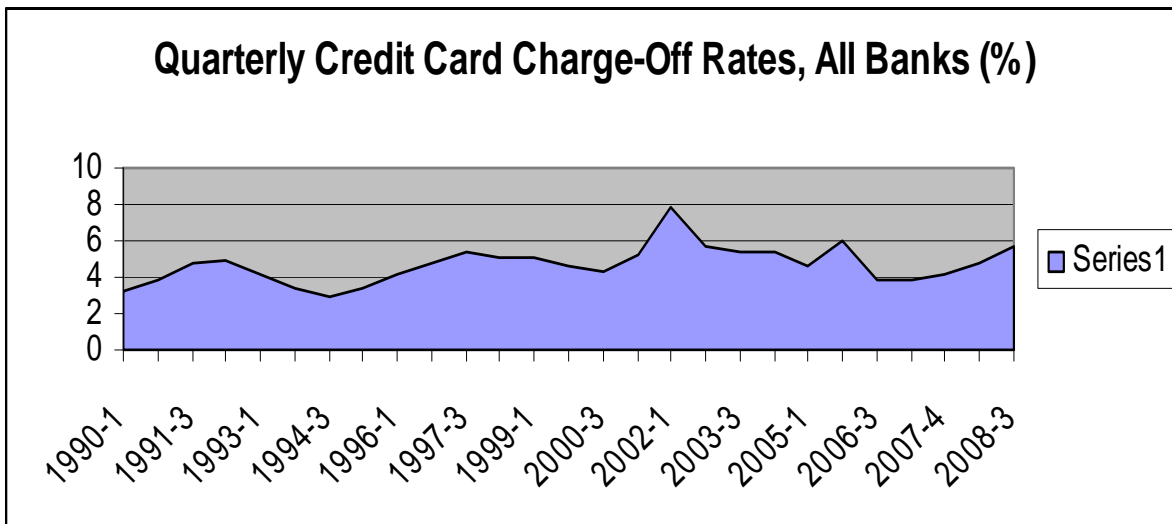
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Gail Hillebrand of Consumers Union, who led the letter, there has been no reply. The letter is available here <http://static.uspirg.org/consumer/archives/TALF.pdf>,

<sup>15</sup> Chu, Kathy, "November Credit-Card Payoff Rate Fell Sharply," *USA Today*, February 8, 2009. The monthly payment rate fell by 2.5 percentage points to 16.1 percent in November 2008, according to CardTrak.com.

start of 2006, credit card charge-offs were not below 4 percent in a single quarter.<sup>16</sup> They increased to more than 4 percent in the fourth quarter of 2006 and broke 4 percent again during the later half of 2007. Since then, charge-offs have escalated sharply to 5.62 percent in the third quarter of 2008. There is a very good chance that charge-offs will keep rising because the number of delinquent credit card payments – an early sign of payment difficulty – are also approaching historically high levels. Thirty-day credit card delinquencies are now at their highest point in six years, since the last economic recession ended.<sup>17</sup> Moreover, a number of major issuers have reported fourth quarter charge-offs that indicate that borrower defaults and issuer losses will exceed those of the last two recessions.<sup>18</sup> The difficulty that many families are having affording their credit card bills has been exacerbated by the mortgage crisis. As home values have dropped sharply, Americans have been unable to use home equity loans and home refinancing to pay off their credit card debts.<sup>19</sup> Moreover, despite rising credit card delinquencies, there is evidence that some families are attempting to stay current on their credit card loans but not their mortgage payments, a shift in behavior from past economic crises.<sup>20</sup>

Quarterly Credit Card Charge-Off Rates, All Banks (%)<sup>21</sup>



Source: Federal Reserve.

<sup>16</sup> Federal Reserve Board, “Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks,” available at [www.federalreserve.gov/release/chargeoff](http://www.federalreserve.gov/release/chargeoff). Most experts attribute lower charge-offs in 2006 to the surge of bankruptcy filings (and corresponding increase in charge-offs) that occurred in the third and fourth quarters of 2005.

<sup>17</sup> 30-day credit card delinquencies during first three quarters of 2008 were between 4.79 and 4.88 percent, the highest levels since 2002. Federal Reserve Board, “Charge-Off and Delinquency Rates on Loans and Leases at 100 Largest Commercial Banks” “U.S. Credit Card Delinquencies at Record Highs – Fitch,” *Reuters*, February 4, 2009.

<sup>18</sup> Terris, Harry, “Credit Card Losses Seen Surpassing Levels of Last Two Recessions,” *American Banker*, January 28, 2009.

<sup>19</sup> Westrich, Tim and Weller, Christian E., “House of Cards, Consumers Turn to Credit Cards Amid the Mortgage Crisis, Delaying Inevitable Defaults,” Center for American Progress, February 2008.

<sup>20</sup> Chu, Kathy, “More Americans Using Credit Cards to Stay Afloat,” *USA Today*, February 28, 2008.

<sup>21</sup> Federal Reserve Board, “Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks,” available at [www.federalreserve.gov/releases/chargeoff/chgallsa.htm](http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm), accessed April 14, 2008.

Although some issuers have suffered losses in the last year, over time the credit card industry has been the most profitable in the banking sector, earning a return on assets (ROA) from 1995 to 2008 that was more than three times greater than that for commercial banks overall.<sup>22</sup> Because of the high mortgage losses that many large banks experienced in 2007, there was more than a five-fold difference between bank and credit card profits.<sup>23</sup>

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

It is conventional wisdom that consumer demand fueled the growth of revolving debt to about \$964 billion.<sup>24</sup> However, a careful analysis of lending patterns by credit card companies shows that aggressive and even reckless lending by issuers played a huge role in pushing credit card debt to record levels. From 1999 through 2007, creditor marketing and credit extension increased about twice as fast as credit card debt taken on by consumers,<sup>25</sup> even though the rate of growth in credit card debt in 2007 was the highest it had been since 2000.<sup>26</sup>

The debt growth rate started slowing in the second quarter of 2008 and then experienced a rare decline in the fourth quarter.<sup>27</sup> This most significant reason for this drop was probably the decline in consumer spending brought on by the recession. Additionally, issuers significantly reduced their marketing of new credit and started reducing some existing credit lines in the latter half of 2008.<sup>28</sup>

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<sup>22</sup> “Card Profits 04,” *CardTrak*, January 24, 2005; “Banner Year,” *CardTrak*, February 2004; FDIC, *FDIC Quarterly Banking Profile*, Third Quarter 2006 at 5, Table I-A; FDIC, *FDIC Quarterly Banking Profile*, Fourth Quarter 2000 at 4, Table I-A. Commercial banks’ average return on assets between 1995 and 2004 was 1.23 percent, less than one third the size of the credit card industry average return on assets of 3.73 percent over the same period, according to R.K. Hammer and Associates.

<sup>23</sup> ROA for credit card issuers in 2007 was 4.65%, R.K. Hammer and Associates, January 2008. ROA for commercial banks in 2007 was .86%, FDIC, “Banks and Thrifts Earned \$105.5 billion in 2007,” February 26, 2008.

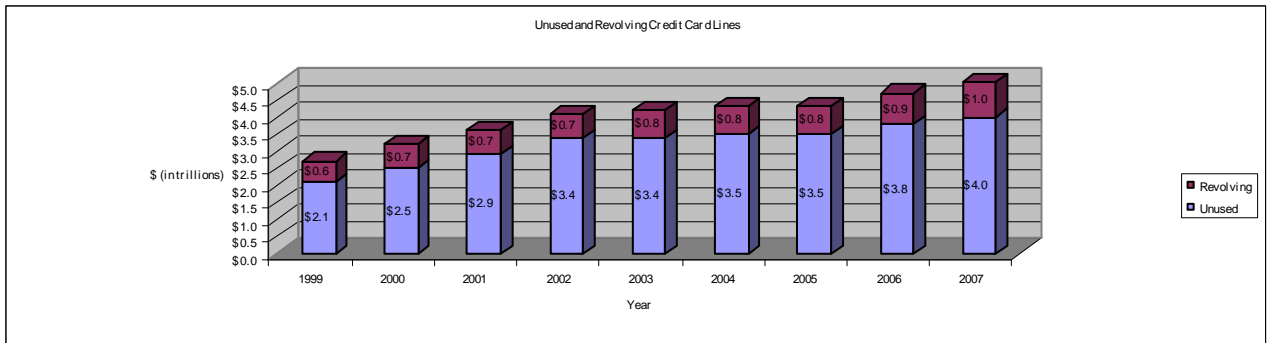
<sup>24</sup> As of December 2008, the amount of revolving debt held by Americans was \$963.5 billion. Although this figure is often used as a proxy for credit card debt, most experts believe that outstanding credit card debt is slightly lower. First, approximately 5 percent of consumer revolving credit is not on credit cards. Second, between 4 to 9 percent of the debt does not truly revolve. It is repaid to the credit card issuer before the next billing cycle starts. Taking these two factors into account, outstanding credit card debt is likely to be between \$829 and \$877 billion.

<sup>25</sup> VERIBANC, Inc. ([www.VERIBANC.com](http://www.VERIBANC.com)) and Federal Reserve Consumer Credit Outstanding. According to Federal Reserve figures, consumer revolving debt grew by 50 percent from \$627.5 billion in December 1999 to \$941.4 billion in December 2007. According to VERIBANC, unused lines of credit grew at almost double the rate (90.5 percent) that consumers increased their use of credit card lines, increasing from \$2.1 trillion in 1999 to just under \$4.0 trillion (\$3,983,200,614) at the end of 2007.

<sup>26</sup> The amount of revolving debt increased by 7.8 percent in 2007, which was the sharpest increase since revolving debt grew by 11.6 percent in 2000. Federal Reserve, Statistical Release, “Consumer Credit Outstanding,” Table G.19.

<sup>27</sup> The amount of credit card debt in the fourth quarter of 2008 dropped by 5.4 percent, from \$976.7 billion to \$963.5 billion. Federal Reserve, Statistical Release, “Consumer Credit Outstanding,” Table G.19.

<sup>28</sup> Wolfe, Daniel, “Top Issuers, with Less Appetite for Risk, Slashing Credit Lines,” *American Banker*, December 2, 2008. Banjo, Shelly, “Credit Card Companies Slash Credit Limits,” *The Wall Street Journal*, January 5, 2009.



Source: VERIBANC, Federal Reserve.

A similar trend is evident when examining the consumer response to massive increases in marketing by creditors that started in 1990. The most significant form of marketing for creditors remains solicitation by mail. Over half of credit cards held by consumers are the result of mail solicitation.<sup>29</sup>

Issuers increased the number of mailed credit card offerings six-fold from 1990 to 2005, from just over 1.1 billion to a record 6.06 billion.<sup>30</sup> Since then, solicitations dropped to 5.8 billion in 2006, 5.2 billion in 2007, and 3.8 billion in 2008.<sup>31</sup> Wealthier families receive the highest number of credit card mailings, but low-income families are more likely to open the solicitations they receive.<sup>32</sup> The table at right indicates that issuer interest in marketing credit cards grew much faster than consumer interest in accepting new cards. The consumer response rate to mail solicitations declined seven-fold from 2.1 percent in 1990 to 0.3 percent in 2005, picking up slightly to 0.5 percent in 2006 and 2007. This means that for every 250 solicitations consumers receive, they reject more than 249. The tiny response rate demonstrates that the vast majority of consumers are being responsible when offered unsolicited credit.

<sup>29</sup> Vertis Inc., press release, “Financial Direct Mail Readers Interested in Credit Card Offers,” January 25, 2005; “Card Marketing 101,” *CardTrack*, September 2002.

<sup>30</sup> Synovate Mail Monitor, press release, “Mail Monitor Reports Record Six Billion Credit Card Offers Mailed in U.S. during 2005,” April 27, 2006.

<sup>31</sup> Synovate Mail Monitor, press release, “U.S. Credit Card Mail Volume Declined to 3.8 billion in 2008,” January 30, 2009.

<sup>32</sup> Kidane, Amdetsion and Sandip Mukerji, Howard University School of Business, “Characteristics of Consumers Targeted and Neglected by Credit Card Companies,” *Financial Services Review*, Vol. 13, No. 3, 2004 at 186.

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

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

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.<sup>34</sup> According to the Federal Reserve Board, about 42 percent of cardholding households pay their credit card bill in full every month,<sup>35</sup> which means that the remaining 50 million or so families that carry debt owe an average of about \$17,000.<sup>36</sup>

|      | Solicitations (billions) <sup>33</sup> | Response Rate |
|------|--|---------------|
| 1990 | 1.1                                    | 2.1%          |
| 1991 | 0.99                                   | 2.4%          |
| 1992 | 0.92                                   | 2.8%          |
| 1993 | 1.5                                    | 2.2%          |
| 1994 | 2.5                                    | 1.6%          |
| 1995 | 2.7                                    | 1.4%          |
| 1996 | 2.38                                   | 1.4%          |
| 1997 | 3.01                                   | 1.3%          |
| 1998 | 3.44                                   | 1.2%          |
| 1999 | 2.54                                   | 1.0%          |
| 2000 | 3.54                                   | 0.6%          |
| 2001 | 5.01                                   | 0.6%          |
| 2002 | 4.89                                   | 0.5%          |
| 2003 | 4.29                                   | 0.6%          |
| 2004 | 5.23                                   | 0.4%          |
| 2005 | 6.06                                   | 0.3%          |
| 2006 | 5.8                                    | .5%           |
| 2007 | 5.2                                    | .5%           |

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

<sup>33</sup> Synovate Mail Monitor

<sup>34</sup> Cardweb.com

<sup>35</sup> Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,” Federal Reserve Bulletin, vol. 92, February 2006, pg. 31.

<sup>36</sup> CFA calculation based on estimated credit card (as opposed to revolving) debt of \$850 billion. If a conservative estimate of 75 percent of 114.4 million households have credit cards, and only 58 percent of these households carry debt, then the remaining 49.7 million households have an average of \$17,103 in debt.

## Lower-Income and Minority Households

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

## Younger and Older Americans

Starting in the early 1990's, credit card issuers targeted massive marketing efforts at college campuses throughout the country, resulting in a sharp growth of credit card debt among college-age and younger Americans. CFA,<sup>41</sup> with Dr. Robert Manning, and U.S. PIRG<sup>42</sup> were among the first to document the serious consequences of this trend. Since Dr. Manning's report for CFA in 1999, this issue has been the subject of much public and media scrutiny. And yet, Americans under 35 years-of-age continue to show more signs of trouble managing credit card debt than any other age group. The amount of credit card debt held by students graduating from college more than doubled to \$3,262 between the mid-1990s and 2004.<sup>43</sup> Americans under

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<sup>37</sup> Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 92, February 2006, pg. 24.

<sup>38</sup> Board of Governors of the Federal Reserve System, "Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency," submitted to the Congress pursuant to section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, June 2006 at 9 Table 6.

<sup>39</sup> Gallup Poll News Service, "Average American Owes \$2,900 in Credit Card Debt," April 16, 2004.

<sup>40</sup> Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. In 2001, more than one in four (27.0%) families in the lowest income quintile spent more than 40% of their income on debt payments, compared to less than one in six (16.0%) of families in the second lowest income quintile and one in nine (11.0%) of all families who spent 40% or more of their income on debt payments.

<sup>41</sup> Manning, Robert, "Credit Cards on Campus: Costs and Consequences of Student Debt," June 8, 1999. CFA Press Release available at: <http://www.consumerfed.org/ccstudent.pdf>

<sup>42</sup> Mierzwinski, Edmund, "The Campus Credit Card Trap," April 1998, U.S. PIRG Education Fund; Mierzwinski, Edmund and Lindstrom, Christine, "The Campus Credit Card Trap: A Survey of College Students and Credit Card Marketing," March 2008, U.S. PIRG Education Fund; Mierzwinski, Edmund and Lindstrom, Christine, "Characteristics of a Fair Campus Credit Card," U.S. PIRG Education Fund, April 2008. Both of the 2008 reports are available at <http://www.truthaboutcredit.org>.

<sup>43</sup> Trigaux, Robert, "Generation Broke: New Grads Bear Heavy Load," *St. Petersburg Times*, November 22, 2004.

35 are less likely to pay off their credit card balances every month than average Americans,<sup>44</sup> are paying more for debt obligations than in the past and are increasingly likely to pay more than 40 percent of their incomes on credit card debt.<sup>45</sup> Not surprisingly, more young Americans are declaring bankruptcy than in the past.<sup>46</sup> Moreover, there is increasing evidence that issuers are now targeting high school students with credit card offers.<sup>47</sup> They are also marketing branded debit cards to adolescents, in part to encourage these young consumers to use similarly branded credit cards when they are older.<sup>48</sup> U.S. PIRG's most recent report also documented intense marketing of credit cards on college campuses and the growing use of contracts between colleges (sometimes through their alumni associations) and credit card companies for exclusive marketing of both credit and debit cards to college students.<sup>49</sup>

The growth of credit card debt among older households is also troubling. Although these households were long thought to be the most frugal and resistant to consumer debt, changing economic conditions – especially declining pension and investment income coupled with rising health care and prescription costs – have made credit card debt a more serious financial issue for older Americans. Between 1992 and 2001, Americans over age 65 saw their credit card debt nearly double from \$2,143 to more than \$4,000.<sup>50</sup> The number of seniors filing for bankruptcy more than tripled from 1991 to 2001.<sup>51</sup> Other warning signs are also evident. The proportion of income spent to pay off debts by households headed by individuals 65 to 74 years of age has risen steadily over the past decade<sup>52</sup> while about one in seven senior households paid more than 40 percent of their income towards their debts in 2001.<sup>53</sup>

Seniors have fewer credit cards than other age groups and are more likely to pay their credit cards in full every month, but a greater proportion of older Americans also have lower

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<sup>44</sup> Draut, Tamara, Director of Demos Economic Opportunity Program, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 8. More than half (55%) of Americans carry revolving balances compared to 71% of borrowers aged 25-34.

<sup>45</sup> *Ibid.* at 4-5. In 1992, about one in thirteen (7.9%) Americans aged 25-34 had debt greater than 40% of their income; by 2001, about one in eight (13.3%) had these high debt burdens.

<sup>46</sup> Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001.

<sup>47</sup> Mayer, Caroline E., "Girls Go From Hello Kitty To Hello Debit Card; Brand's Power Tapped to Reach Youth," *The Washington Post*, October 3, 2004.

<sup>48</sup> Ludden, Jennifer, "Credit Card Companies Target Kids," *All Things Considered*, National Public Radio, February 6, 2005.

<sup>49</sup> Testimony of Christine Lindstrom, Director U.S. PIRG Higher Education Program, at a hearing on "Problem Credit Card Practices Affecting Students: The Need for Legislative Action," before the Subcommittee on Financial Institutions, June 26, 2008 available at <http://financialservices.house.gov/hearing110/hr0626084.shtml>.

<sup>50</sup> Demos, "Retiring in the Red," January 19, 2004 at 3.

<sup>51</sup> Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001, at 5. The number of older Americans declaring bankruptcy during this period rose from 23,890 to 82,207.

<sup>52</sup> Aizcorbe, Kennickell and Moore 2003 at 28, Table 14. According to the Federal Reserve Survey of Consumer Finances, the median debt services ratio of households aged 65-74 grew by 54% from 9.8% in 1992 to 15.1% in 2001 and the debt services ratio for households 75 and older grew 169% from 2.6% to 7.0% in 2001.

<sup>53</sup> *Ibid.* 13.9% of households aged 65-74 and 14.3% of households aged 75 and over spent more than 40 percent of their income on debt service.

incomes.<sup>54</sup> This means that credit card debt has a more severe impact on this age group. For example, credit card debt can threaten older homeowners, who stand to lose their home – and their most significant hedge against poverty – if they use home equity to pay off credit card debt.

### The Downsizing of Minimum Payments

As credit card issuers dramatically expanded their marketing and extension of credit in the 1990s, they lowered monthly minimum payment amounts. By reducing the minimum payment, issuers could offer more credit, encourage consumers to take on more debt, and ensure that consumers would take far longer to pay off their debts, thus making them more profitable for the industry.<sup>55</sup> Monthly minimum payment rates were reduced from around 5 percent of principal owed in the 1970s to just over 2 percent by the turn of the century.<sup>56</sup> In 2005, 19 million credit card borrowers make only the minimum payments.<sup>57</sup>

The number of consumers paying just above the minimum rate is even larger. In a representative survey conducted for the Consumer Federation of America by Opinion Research Corporation in November of 2005, 34 percent of those questioned said that they usually pay the minimum rate or somewhat more. More than 40 percent of respondents earning less than \$50,000 a year said they paid the minimum rate or somewhat more, while 45 percent of African Americans and 51 percent of Hispanics did so.<sup>58</sup> An examination by the Credit Research Center of 310,000 active credit card accounts over 12 consecutive months in 2000 and 2001 found similar results. Just under one-third of the accounts paid 5 percent or less per month of the total amount due.<sup>59</sup> Moreover, payment habits for many cardholders are not static over time. Depending on the economic circumstances of the cardholder involved, he or she could shift from fully paying outstanding balances every month to paying at or near the minimum rate.

However, paying only the minimum on credit cards can increase the length of time the debt is carried and significantly add to the interest cost of the credit card loan. Julie Williams, the First Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency (OCC) has noted that reduced minimum payments “dig borrowers into an ever deeper hole, requiring increasingly more difficult measures” for consumers to get out of debt.<sup>60</sup> CFA

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<sup>54</sup> Hanway, Steve, “Do Credit Card Habits Improve with Age?” Gallup News Organization, May 18, 2004. Nearly half (48%) of households over 65 years old have incomes below \$30,000, compared to 16% of those aged 30-49 and 18% of those aged 50-64.

<sup>55</sup> Interview with Andrew Kahr, credit card industry consultant, “The Secret History of the Credit Card,” *Frontline*, November 2004.

<sup>56</sup> Kim, Jane J., “Minimums Due on Credit Cards are on the Increase,” *Wall Street Journal*, March 24, 2005.

<sup>57</sup> Der Hovanesian, Mara “Tough Love for Debtors,” *Business Week*, April 25, 2005.

<sup>58</sup> Opinion Research Corporation, “Consumer Financial Services Survey,” November 3-7, 2005.

<sup>59</sup> Credit Research Center, McDonough School of Business, Georgetown University.

<sup>60</sup> OCC, Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel before the Risk Management Association’s Retail Risk Management Conference on Regulatory Concerns about Certain Retail Banking Practices, Chicago, June 3, 2003, in “Speeches and Congressional Testimony,” *OCC Quarterly Journal*, Vol. 22, No. 3, September 2003 at 107.

has concluded that reduced minimum payments were a significant cause of increasing bankruptcies in the last decade.<sup>61</sup>

One way to alert consumers to the consequences of paying off credit card balances at the minimum rate is to offer each consumer a personalized notice on the billing statement about how long it would take to pay off the balance at the minimum rate, and what would be the total costs in interest and principal.<sup>62</sup> Such a personalized disclosure is, unfortunately, not included in the recent bankruptcy law, which requires consumers to call a toll-free number to get information about how long it would take to pay off their balances.<sup>63</sup> No specific information would be offered on the total cost of paying at the minimum rate. This bankruptcy law requirement will likely have no impact on the millions of consumers paying at or near the minimum rate who will not call a toll-free phone number.

One positive development regarding credit card minimum payments is that regulatory guidance issued by federal banking regulators in January 2003 directed credit card lenders to set minimum payments that “amortize the current balance over a reasonable period of time” and noted that prolonged negative amortization would be subject to bank examiner criticism.<sup>64</sup> Many major credit cards began increasing their minimum payments requirements in 2005, including Bank of America, Citibank, Discover and JP Morgan Chase,<sup>65</sup> in some cases to as high as 4 percent.<sup>66</sup> All issuers were required to fully phase in the changes by the end of 2006.<sup>67</sup>

The Office of the Comptroller of the Currency (OCC) has warned banks that increasing minimum payments may need to be accompanied by a reduction in Annual Percentage Rates (APRs) or eliminating fees to ensure that cardholders can actually reduce their balances and not just tread water with higher minimum bills.<sup>68</sup> Since the increases took effect, consumers with interest rates above 20 percent have had to cope with payments that have roughly doubled.<sup>69</sup>

### Targeting Consumers on the Brink of Financial Distress

Nothing illustrates the perverse incentives (and dangers) of the credit card market better than the marketing of cards to consumers with tarnished credit histories, or even worse, to those

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<sup>61</sup> Consumer Federation of America, “Consumer Restraint Pressures Lenders to Reduce Credit Card Marketing and Credit Extension,” January 18, 2000.

<sup>62</sup> Proposed in S. 1176 by Senators Akaka, Durbin, Leahy and Schumer.

<sup>63</sup> Public Law 109-8.

<sup>64</sup> Joint press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, “FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices,” January 8, 2003, see attached “Account Management and Loss Allowance Guidance” at 3.

<sup>65</sup> American Financial Services Association, “Credit Card Minimum Payments Going Up,” *Spotlight on Financial Services*, April 2005.

<sup>66</sup> Warnick, Melody, “Credit Card Minimum Payments Doubling,” *Bankrate.com*, May 3, 2005. Citibank and Bank of America have announced they are doubling their minimum payment requirements from 2% to 4% of the balance.

<sup>67</sup> Day, Kathleen and Caroline E. Mayer, “Credit Card Penalties, Fees Bury Debtors,” *Washington Post*, March 6, 2005.

<sup>68</sup> Der Hovanesian, Mara “Tough Love for Debtors,” *Business Week*, April 25, 2005.

<sup>69</sup> “Minimum Payments,” *CardTrack*, September 6, 2006.

who are literally on their way to or just coming out of bankruptcy. For example, in the first half of 2007, as home mortgage foreclosures shot up and signs of a serious economic slowdown started to appear, some of the nation's largest credit card issuers increased the number of solicitations they mailed to sub-prime consumers by 41 percent compared to the first half of 2006.<sup>70</sup>

Other major issuers and many smaller companies market high-cost, sub-prime cards to those with blemished credit histories. This population of cardholders can be profitable for the industry. Credit card industry consultant Andrew Kahr estimates that average sub-prime consumers will make two or three late payments a year, from which the industry can generate a separate fee, and that these fees can greatly exceed the interest payments on the small lines of credit themselves.<sup>71</sup>

Sub-prime consumers haven't just encountered high-cost offers of credit, but deceptive marketing practices. In 2000, Provident was required to pay more than \$300 million in restitution to its sub-prime cardholders for unfair and deceptive practices.<sup>72</sup> Cross Country Bank, the sub-prime and secured credit card issuer that has been investigated by state and federal regulators for misleading consumers about the terms of its sub-prime credit card accounts and engaging in abusive collection practices, has advertised on late-night and daytime television when more unemployed potential sub-prime customers are more likely to be watching television.<sup>73</sup>

In December of 2008, sub-prime card marketer Compucredit reached a settlement with federal regulators to provide at least \$114 million in consumer redress and pay a \$2.4 million fine for deceptive marketing of high-fee, low-limit credit cards. Among other allegations, Compucredit was accused of marketing cards with a \$300 limit, but failing to adequately disclose the \$185 in fees that would be immediately charged to the card.<sup>74</sup>

Consumers exiting bankruptcy are often swamped with offers at prime terms – low interest rates and without annual fees.<sup>75</sup> Many bankruptcy attorneys believe these offers are being made because consumers leaving bankruptcy court cannot erase their debts for another six years. Under the new bankruptcy legislation consumers will not be able to wipe away any credit card debts for eight years. Some categories of credit card debt will not be “dischargeable” at all, no matter how long the consumer waits.<sup>76</sup>

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<sup>70</sup> Gavin, Robert, “Credit Card Companies Pursue Subprime Borrowers,” *Boston Globe*, September 5, 2007.

<sup>71</sup> Interview with Andrew Kahr, credit card industry consultant, “The Secret History of the Credit Card,” *Frontline*, November 2004.

<sup>72</sup> OCC, Statement of Comptroller of the Currency John D. Hawke J., June 28, 2000.

<sup>73</sup> Pacelle, Mitchell, “Pushing Plastic,” *Wall Street Journal*, November 5, 2004.

<sup>74</sup> “Subprime Credit Card Marketer to Provide At Least \$114 Million in Consumer Redress to Settle FTC Charges of Deceptive Conduct,” Federal Trade Commission, Dec. 19, 2008, <http://www.ftc.gov/opa/2008/12/compucredit.shtm>.

<sup>75</sup> Mayer, Caroline E., “Bankrupt and Swamped with Credit Offers,” *Washington Post*, April 15, 2005.

<sup>76</sup> *Ibid.*

#### **D. ISSUERS HAVE PURSUED ABUSIVE INTEREST RATE, FEE AND RISK MANAGEMENT POLICIES THAT HAVE A HARMFUL IMPACT ON MANY HOUSEHOLDS**

There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. For example, research by Professor Ronald Mann of Columbia University has found that an increase in credit card spending in the U.S. and four other countries has resulted in higher credit card debt, which is strongly associated with an increase in bankruptcy filings.<sup>77</sup> To make matters worse, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices in recent years. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.<sup>78</sup> In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges, as in principal.

High fees and interest rates can often result in negative amortization, where the principal owed on credit card debt continues to rise despite making payments. Negative amortization in effect traps credit card borrowers on a debt treadmill that keeps moving faster. Although they are making regular payments, their debts continue to mount. In 2004, a Cleveland judge ruled against Discover Card's efforts to collect debts from a cardholder whose balance nearly tripled from \$1,900 to \$5,564 without making additional purchases because of fees and penalties, including \$1,158 in over-limit fees alone.<sup>79</sup>

In another case, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it files in chapter 13 bankruptcy cases.<sup>80</sup> In its findings in support of the Order, the bankruptcy judge listed claims filed in eighteen separate cases broken down between principal and interest and fees. On average, interest and fees consisted of more than half (57 percent) of the total amounts listed in the claims. In one case, the card company filed a claim in the amount of \$943.58, of which \$199.63 was listed as principal and \$743.95 was listed as interest and fees. In another case, a claim of \$1,011.97 consisted of \$273.33 in principal and \$738.64 in interest and fees. It is almost certain that pre-bankruptcy payments in these cases had more than paid off the real charges made by the consumers.<sup>81</sup>

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<sup>77</sup> Mann, Ronald J., "Credit Cards, Consumer Credit and Bankruptcy," Law and Economics Research Paper No. 44, The University of Texas School of Law, March 2006.

<sup>78</sup> Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

<sup>79</sup> National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.

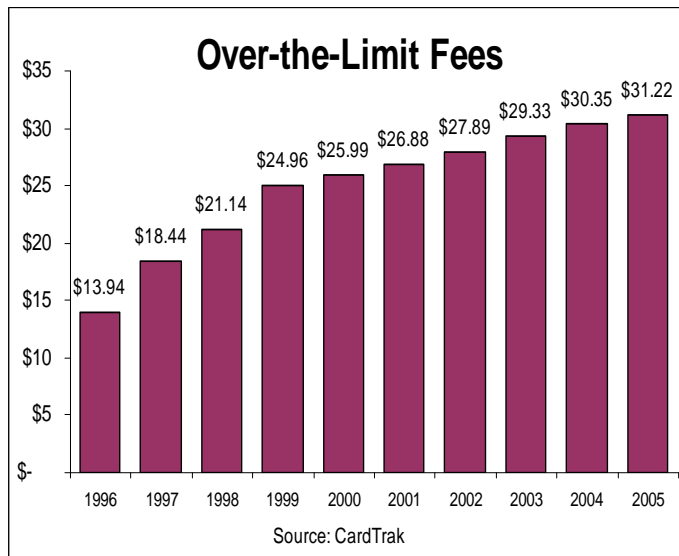
<sup>80</sup> *In re Blair*, No. 02-1140 (Bankrate. W.D.N.C. filed Feb. 10, 2004)

<sup>81</sup> National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.

## Penalty Fees

Traditionally, penalty fees were designed to deter irresponsible cardholder behavior, but in recent years these fees have become primarily a revenue enhancer for credit card issuers. An analysis by the United States Government Accountability Office (GAO) found that, "...typical cards today now include higher and more complex fees than they did in the past for making late payments, exceeding credit limits, and processing returned payments."<sup>82</sup> The GAO also identified several new fees that issuers have begun using in recent years, some of which they are not required to disclose to consumers in advance. One example of such a fee is for the payment of bills by telephone, which can range from 5 to 15 dollars.<sup>83</sup>

A substantial number of Americans are paying these fees. Thirty-five percent of the credit card accounts from the six largest issuers that the GAO examined had at least one late fee in 2005,<sup>84</sup> representing about 242 million credit cards.<sup>85</sup> Thirteen percent of all accounts – or about 90 million cards – were assessed over-limit fees in 2005.



Late fees have been steadily rising over the past decade and can easily exceed monthly payments for consumers paying low minimum balances.<sup>86</sup> In 1996, a Supreme Court decision prohibited states from setting limits on the fees credit card companies could charge their cardholders. Prior to this court ruling, credit card late fees were commonly around five to ten dollars, but have risen sharply since the decision.<sup>87</sup> The GAO analysis found that late fees jumped sharply after the court ruling. The GAO examined fee data collected by CardWeb.com and found that late fees jumped by 160 percent from \$12.83 in 1995 to \$33.64 in 2005. The GAO also found a sharp fee increase from data collected by Consumer Action, which showed a 119 percent increase from \$12.53 in 1995 to \$27.46 in 2005.<sup>88</sup> Even more striking, the GAO found that late fees paid by borrowers with typical balances were an average of \$37 in 2005.<sup>89</sup> This is important to note as credit card issuers are increasingly assessing "tiered" fees based on the borrower's balance.

<sup>82</sup> "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.

<sup>83</sup> *Ibid*, p. 23.

<sup>84</sup> *Ibid*, p. 1.

<sup>85</sup> CFA calculation based on 691 million credit cards, *Ibid*, p. 9.

<sup>86</sup> "The Ugly Issuer," *Credit Card Management*, September 2004.

<sup>87</sup> Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

<sup>88</sup> "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.

<sup>89</sup> *Ibid*, p. 20.

Credit card issuers used to reject transactions that exceeded a cardholder's credit limit, but it has become common for issuers to accept the transaction and then apply an over-limit fee on cardholders who exceed their credit limits.<sup>90</sup> These fees are often applied by issuers in addition to a higher "penalty" interest rate charge for exceeding the credit limit or carrying a high balance.<sup>91</sup> These monthly fees are charged every month a consumer carries a credit balance higher than their credit limit. According to the GAO report, data collected by Consumer Action shows a 114 percent increase in over-limit fees between 1995 and 2005.<sup>92</sup> Critics of this practice argue that issuers should not assess a penalty fee when they can simply enforce the credit limit if they wish to prevent consumers from exceeding it.

### Penalty Interest Rates

The vast majority of credit card issuers also increase interest rates for credit card account holders who pay their bills late, even by a few hours. In 2005, Consumer Action found that 78.7 percent of issuers charged penalty rates for late payments on their cards.<sup>93</sup> For example, representatives for one large issuer told the GAO that they automatically increase a customer's interest rate if this person pays late or exceeds the credit limit. The GAO found that all but one of the 28 cards from the six largest issuers they reviewed charged default rates in 2005. By 2008, 94% of new credit card solicitations included a penalty rate.<sup>94</sup> The average default rate in 2008 is 28.6 percent, up from 23.7 percent in 2003.<sup>95</sup> Even more striking, the spread between the penalty rate and the standard purchase rate more than doubled between 2000 (8.1%) and 2008 (16.9%).<sup>96</sup>

Some consumers with low-rate cards could have their interest rates double overnight for being late on one payment to their credit card.<sup>97</sup> Some issuers also say that they will charge default interest rates for exceeding the credit limit on the card or for returned payments, or that they will increase interest rates for cash advances and balance transfers for violations of card terms.<sup>98</sup>

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<sup>90</sup> "The Ugly Issuer," *Credit Card Management*, September 2004.

<sup>91</sup> Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

<sup>92</sup> "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 20.

<sup>93</sup> Consumer Action, 2005 Credit Card Survey, "Card Companies Use Common 'Risk Factors' to Impose Unfair Rate Hikes, Finds CA," *Consumer Action News*, Summer 2005.

<sup>94</sup> Frank, Joshua M., *Priceless or Just Expensive? The Use of Penalty Rates in the Credit Card Industry*, p. 10, Center for Responsible Lending (December 16, 2008), hereafter Frank, *Priceless or Just Expensive.*, available at <http://www.responsiblelending.org/pdfs/priceless-or-just-expensive.pdf>.

<sup>95</sup> Id at 9. (The 2006 GAO report did find that some issuers do not assess default rates unless there are multiple violations of card terms. "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, pgs. 24, 25.)

<sup>96</sup> Frank, *Priceless or Just Expensive*, at 9-10.

<sup>97</sup> Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

<sup>98</sup> "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 25.

There is increasing evidence that those who can least afford these higher interest rates – financially vulnerable families – are most likely to be paying them. A study by the research organization Demos found that cardholders that carry debt who earn less than \$50,000 a year are more than twice as likely to pay interest rates above 20 percent as the highest income Americans who carry debt. African-American and Latino credit card holders with balances are more likely than whites to pay interest rates higher than 20 percent.<sup>99</sup>

One recent study estimated that the cost of the penalty rate shock cost a revolver carrying the average \$10,678 balance \$1800 a year.<sup>100</sup> At a time when we are looking for ways to put money back in the hands of families, reducing this \$150 a month surtax could have a real stimulative effect.

### Retroactive Application of Penalty Rates

All issuers also apply penalty interest rates retroactively to prior purchases. This has the effect of increasing the price on purchases already made but not paid off.<sup>101</sup> Some cards even apply penalty rates to debts that were already paid at a lower rate.<sup>102</sup> There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance. There is no other industry in the country that is allowed to increase the price of a product once it is purchased. Issuers have already assessed a consumer's risk of not repaying the loan and presumably offered an interest rate based on that risk. Issuers should be required to allow a consumer to pay off his or her existing balance at that interest rate.

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

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<sup>99</sup> Wheary, Jennifer, and Tamara Draut, "Who Pays? The Winners and Losers of Credit Card Deregulation," Demos, August 1, 2007.

<sup>100</sup> Frank, *Priceless or Just Expensive*, at 1.

<sup>101</sup> Draut, Tamara, Director of the Economic Opportunity Program at Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 16-17.

<sup>102</sup> McGeehan, Patrick, "The Plastic Trap," *New York Times*, November 21, 2004. Discover disclosed to its customers that it had changed the terms of its interest rates from a low of zero to 19.99% for a single late payment, but it applied that rate increase for late payments from 11 months prior to the disclosure of the changing interest rate terms.

## Universal Default

Universal default clauses in credit card contracts allow credit card companies to raise interest rates on debtors who have problems with other creditors or whose credit scores decline. The increases are triggered not just by a late mortgage or credit card payment to other lenders but also to payment disputes with other types of creditors, like utilities or book clubs.<sup>103</sup> A review of credit card disclosures issued in October 2006 by Consumer Action found five major issuers that said they reserved the right to assess universal default interest rates. Since that time, Citigroup and JP Morgan Chase have said that they will not use the practice, although Citigroup changed this policy in the fall of 2008.<sup>104</sup> On the other hand, representatives for Bank of America and Discover testified before the Senate late last year that they still use consumer credit scores, at least in part, to trigger higher default interest rates.<sup>105</sup>

It is fundamentally unfair to impose a penalty interest rate on a consumer who has not made a late payment or defaulted on an obligation, especially when this rate increase is applied retroactively. Another concern with using credit reports to trigger a penalty rate is the problems with inaccuracies in credit scoring and credit reporting that CFA and other organizations have documented.<sup>106</sup> Moreover, issuers who impose sharp interest rate increases on consumers who are meeting their obligations often fail to provide any rationale – much less a legitimate one -- for the increase. In January, Bank of America began increasing interest rates on some cardholders to as high as 28 percent but did not inform consumers the reason for the increase in the notification they mailed.<sup>107</sup>

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

## Indiscriminate, Undisclosed Changes in Rates and Fees

Many credit card companies reserve the right to change the terms of their credit card contract at any time and for any, *or no*, reason. This allows credit card companies to arbitrarily raise interest rates even for cardholders in good standing and with perfect credit histories. Media reports of recent rate hikes by Bank of America demonstrate the unfairness of any-time/any-

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<sup>103</sup> Burt, Bill, "Pay One Bill Late, Get Punished by Many," *Bankrate.com*, January 20, 2004.

<sup>104</sup> Dash, Eric, "Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult' Environment," *New York Times*, November 15, 2008.

<sup>105</sup> Credit Card Practices: Unfair Interest Rate Increases, U.S. Senate Permanent Subcommittee on Investigation, December 4, 2007.

<sup>106</sup> Consumer Federation of America and National Credit Reporting Association, "Credit Score Accuracy and Implications for Consumers," December 17, 2002. CFA and NCRA reviewed over 500,000 credit files and found that 29 percent of consumers have credit scores that differ by at least 50 points between the credit bureaus.

<sup>107</sup> "A Credit Card You Want to Toss," *Business Week*, February 7, 2008.

reason changes: some consumers saw their interest rates triple without explanation.<sup>108</sup> The result of these unfair clauses is that consumers can't depend on the interest rate promised to them.

In the last few months, JP Morgan Chase has begun charging approximately 400,000 cardholders a \$10 a month fee. It is also increasing the minimum payment amount for these consumers from 2 to 5 percent, a substantial amount. Many of these cardholders appear to have been promised a fixed interest rate for the life of the balance.<sup>109</sup>

### Pricing Tricks: Double Cycle Billing and Manipulation of Payment Allocation

The GAO found that two of six major creditors are using a practice called double-cycle billing, which results in illegitimate interest charges on balances that have already been paid on time.<sup>110</sup> Since then, one of these issuers, JP Morgan Chase, has announced that it will no longer use double-cycle billing. With this practice, issuers consider two billing cycles in assessing interest. A consumer who begins with no balance and pays off most but not all of the purchases he or she makes in the first month would still be charged interest for the entire amount of the balance in the second month. A fair billing process would only result in an interest charge on the amount of the unpaid balance.

The GAO also determined that for 23 of the 28 large issuer cards they reviewed, cardholder payments were first allocated to the balance assessed at a lower rate of interest.<sup>111</sup> The actual proportion of large issuers who in effect use this policy is likely closer to 100 percent since the remaining five issuers applied payments "subject to their discretion". This practice is problematic for the many cardholders who now carry balances at different rates of interest, such as introductory "teaser" rates, cash advance rates, and balance transfer rates. The lower interest rate balances must first be paid off before the issuer will allocate payments to higher rate balances. Allocating payments to lower interest rate balances first unfairly extends the length of time it takes consumers to pay down their balances while increasing the finance charges that issuers earn. Furthermore, a recent study has shown this payment allocation policy and its impact to be very poorly understood by consumers.<sup>112</sup> The study also showed this issuer policy causes pricing to be less related to risk, the opposite of what issuers claim they wish to achieve.

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

Penalty fees and interest made up more than three-quarters of credit card issuers revenues throughout 2002 and 2003. Credit card issuers earned \$65.4 billion in interest and \$7.7 billion in penalty fees in 2003 or 75.7 percent of the total \$96.5 billion in revenue.<sup>113</sup> In 2002, penalty fees

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<sup>108</sup> Ibid.

<sup>109</sup> Chu, Kathy, "Chase Adds Fee for Low-Rate Credit Cards," *USA Today*, February 9, 2009.

<sup>110</sup> "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 27.

<sup>111</sup> Ibid.

<sup>112</sup> Frank, Joshua M., *What's Draining Your Wallet? The Real Cost of Credit Card Cash Advances*, Center for Responsible Lending (December 16, 2008), available at <http://www.responsiblelending.org/pdfs/whats-draining-your-wallet.pdf>.

<sup>113</sup> Daly, James J., "Smooth Sailing," *Credit Card Management*, May 2004 at 31.

and interest made up 76.8 percent of the industry's \$97.1 billion in revenues. For the approximately 88 million credit cardholding households, penalty fees and interest on their credit card debt cost an average of \$830 in 2003.<sup>114</sup>

### Unsavoury Credit Limit Practices

In its 2008 survey of credit card terms and conditions, Consumer Action identified some unsavoury credit limit practices used by major credit card issuers. While reducing credit availability can be a responsible way for credit card issuers to manage growing financial risk during difficult economic times, these aggressive credit line policies can harm consumers. Each in its own way puts consumers at greater risk of being charged higher interest rates, falling deeper in debt, and causing a ripple effect among issuers. Consumers reported some credit limit practices to Consumer Action that are patently unfair.

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

### The Combined Effect of Abusive Practices during the Recession

Although credit card issuers have curbed aggressive marketing and cut back on credit extension in the last year, they appear to be accelerating the use of many of the irresponsible and harmful practices detailed above to cut or mitigate their losses. For example, card issuers have used their ability to unilaterally change the terms of credit card contracts by raising interest rates even as the Federal Reserve has sharply reduced the federal funds rate.<sup>115</sup> They have also added new fees,<sup>116</sup> increased the amount of fees,<sup>117</sup> and, as detailed above, used harmful rather than responsible methods to lower credit lines. Citigroup back-peddled last fall on its promises not to increase interest rates "at any time for any reason."<sup>118</sup> As mentioned above, Chase has suddenly

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<sup>114</sup> CFA calculation from Daly, James J. 2004 and Census Bureau figures.

<sup>115</sup> Trejos, Nancy, "Less Power to Purchase, Consumers' Credit Card Limits Slashed as Companies Try to Reduce Risk," *Washington Post*, November 16, 2008.

<sup>116</sup> Lieber, Ron, "Credit Card Companies Go to War Against Losses," *New York Times*, January 31, 2008.

<sup>117</sup> Trejos, Nancy, "Less Power to Purchase, Consumers' Credit Card Limits Slashed as Companies Try to Reduce Risk," *Washington Post*, November 16, 2008.

<sup>118</sup> Dash, Eric, "Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult' Environment," *New York Times*, November 15, 2008.

started charging hundreds of thousands of cardholders fees of \$120 a year, while sharply increasing the monthly amount that these cardholders owe each month. Bank of America and Capital One have used vague clauses in cardholder agreements to raise interest rates on cardholders because of “market conditions.”<sup>119</sup> Issuers have every right to try and limit their losses during the current economic crisis if they act responsibly, but the use of these harmful, unjustified and sometimes arbitrary practices is contributing to the economic insecurity of millions of families who thought they were complying with their obligations.

### When “Risk-Based” Pricing is Predatory

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

The key question is whether interest rates and fees charged to riskier consumers are fair and can be legitimately related to the actual financial risk incurred by creditors. There is increasing evidence that the answer to this question is “no.”<sup>120</sup> It is becoming more apparent that many of the most abusive fees and interest rates are assessed simply because it is what the market will bear.

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

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<sup>119</sup> “Card Rates Rise ‘Out of the Blue,’” *The Oregonian*, January 25, 2008. Kimes, Mina, “Card Companies Jacking Up Rates,” *Cable News Network*, [http://money.cnn.com/2008/09/26/news/economy/creditcards\\_kimes.fortune/](http://money.cnn.com/2008/09/26/news/economy/creditcards_kimes.fortune/).

<sup>120</sup> Testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center, before the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee of the United States House of Representatives, March 13, 2008.

from about 19 percent in 2003 to 22 percent in 2005 on the 28 large issuer cards they evaluated.<sup>121</sup>

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

#### **E. AMERICANS ARE HIGHLY CRITICAL OF MANY CURRENT CREDIT CARD PRACTICES**

Our organizations regularly conduct public opinion surveys regarding consumer attitudes and behavior. We have rarely encountered the kind of broad, nearly universal condemnation that Americans have for many common practices used by credit card issuers regarding interest rates, fees and the extension of credit.

For example, a nationally representative poll of 1,005 adults conducted by the Opinion Research Corporation for the Consumer Federation of America from September 13 to September 16, 2007 found that:

- 82 percent of Americans think it is unfair to offer several credit cards to a student with little income. (62 percent believe it is very unfair.)
- 91 percent of Americans think it is unfair to raise interest rates or fees at any time for any reason. (76 percent believe it is very unfair.)
- 83 percent of Americans think it is unfair to increase the interest rate on one card because of a person’s payment history on another card. (62 percent believe it is very unfair.)
- 84 percent of Americans think it is unfair to apply interest rate increases not only to new balances but also to past balances. (61 percent believe it is very unfair.)
- 85 percent of Americans think it is unfair to increase an interest rate to 30 percent for making two late payments. (64 percent believe it is very unfair.)
- 76 percent of Americans think it is very unfair to charge \$30 for making a late payment. (51 percent believe it is very unfair.)
- 82 percent of Americans think it is unfair to charge a \$30 fee each month if a balance is over the credit limit when a person is no longer using the card. (64 percent believe it is very unfair.)
- 90 percent of Americans think it is unfair to charge \$10 for payment by phone. (72 percent believe it is very unfair.)
- 80 percent of Americans think it is unfair to not allow a person to pay off higher-interest rate debt first, such as on a cash advance, but instead applying payments first to lower-rate debt. (54 believe it is very unfair.)
- 81 percent of Americans think it is unfair to have only one week between the time a person receives a monthly statement and the time he or she must mail the payment. (54 percent believe that it is very unfair.)
- 93 percent of Americans think it is unfair to charge a late fee even though a person has mailed the payment a week or more in advance of the due date. (79 percent believe that it is very unfair.)
- 71 percent of Americans think it is unfair to require that disputes be settled by mandatory arbitration without being allowed to go to court. (45 percent believe that it is very unfair.)

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<sup>121</sup> “Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers,” U.S. Government Accountability Office, September 2006, p. 24.

## F. FEDERAL RULE ON UNFAIR AND DECEPTIVE CREDIT CARD PRACTICES

On December 18, 2008, the Federal Reserve Board, the Office of Thrift Supervision and the National Credit Union Administration issued a final rule to curb unfair and deceptive practices by credit card issuers. The rules do not take effect until July 1, 2010.<sup>122</sup>

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

- **Interest rate increases on existing balances, unless the cardholder is more than 30 days delinquent.** The rule does not prohibit prospective “universal default” rate increases because of a supposed problem that the cardholder has with another creditor. It does eliminate the practice as applied retroactively, which has provided a major financial incentive for issuers to use it, though consumers struggling with their debt, who have missed a payment, could still be hit with large retroactive rate increases. The rule prohibits issuers from increasing interest rates on existing balances because a cardholder has made a minor mistake, such as paying late by a few days.
- **Payment allocation methods that cause debts to escalate.** The rule takes steps to require credit card issuers to more fairly apply the payments that cardholders make to balances with different interest rates. When consumers transfer balances with low, short-term “teaser” rates (that have higher rates for new purchases), or take out high-rate cash advances, issuers will be required to apply payments either to the higher rate debt or to both the higher and lower rate debt proportionately. Currently, credit card issuers apply payments only to the lower rate debt. Though the rule improves current payment allocation practices significantly, consumers would still be unable to completely pay off costly high rate balances by making extra payments unless the consumer pays off the lower rate balances at the same time.
- **Interest charges on debts that have already been paid.** The rule forbids “double cycle billing,” which results in cardholders paying interest on debts paid off the previous month during the grace period.
- **Excessive fees for low-credit cards.** The rule forbids credit card companies that target consumers with poor credit histories from requiring consumers to pay fees that amount to more than half of the credit being offered, if those fees are charged to the card that is being issued. If the fees being charged to the card amount to more than one-quarter of the credit line, cardholders will be allowed to pay these fees off over a six-month period.

The rule is an important first step in stopping issuers from using some unfair and deceptive practices to increase the amount of debt consumers owe. However, it is not helpful to consumers struggling to pay off hefty debts in the middle of a recession to allow issuers to

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<sup>122</sup> Federal Reserve System, 12 CFR Part 227 [Regulation AA; Docket No. R-1314]; Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 535 [Docket ID. OTS-2008-0027] RIN 1550-AC17; National Credit Union Administration, 12 CFR Part 706, RIN 3133-AD47; Unfair or Deceptive Acts or Practices.

continue to use for another year and a half practices that federal regulators have deemed to be abusive. We urge this Subcommittee to provide consumers with more timely relief, and to address abusive practices that are not targeted or completely eliminated by the rule. The Credit Cardholders' Bill of Rights Act achieves both of these goals. (See Section H for discussion of this bill and how it compares to the regulators' rule.)

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

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

A diverse coalition of more than twenty organizations led by Consumers Union has called on Secretary Geithner to require that any securitized debt whose purchase is financed through this program meet standards for fairness and truthfulness, including those standards were finalized in December 2008 by the Federal Reserve Board.<sup>123</sup> The groups sought this change to ensure that any consumer credit card debt facilitated through this taxpayer-backed program will promote, rather than damage, household economic stability.

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

1. Immediate compliance with details of the rule against unfair or deceptive acts or practices for all consumer credit card debt in the pool; and
2. A specific program for cardholders to earn a reduction in penalty interest rates back to a lower standard rate after no more than six months of on-time payments for all consumer credit card debt in the pool.

Any government backed program to make capital available for credit card debt must be limited to that credit card debt which is not associated with practices that federal regulators have determined to be unfair or deceptive. Federal backing of credit card securitizations must also be

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<sup>123</sup> <https://mail.consumerfed.org/exchweb/bin/redir.asp?URL=http://www.consumersunion.org/pdf/TALF.pdf>.

limited to credit card debt with a clear “road map” to non-penalty rates for households who pay on time while under a penalty rate.

A stated purpose for the Troubled Assets Relief Program (TARP) is to restore stability to the financial system. However, the first installment of TARP money did not even begin to promote financial stability for borrowers, homeowners, and communities in the face of the tide of foreclosures, onerous credit card practices, and the crying need for affordable, sustainable, systematic loan modifications. The new TALF program for non-mortgage debt should limit its offer of liquidity to avoid the type of credit card debt that detracts from sustainable lending and household financial stability.

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

#### **H. H.R. 627**

The “Credit Cardholders' Bill of Rights Act” helps restore fairness to the credit card marketplace. The bill would require credit card issuers to take a number of steps to treat consumers more fairly, including:

1. **Ending Bait and Switch Contract Clauses.** H.R. 627 invokes the basic tenet of fair dealing by prohibiting credit card companies from changing contract rules in the middle of the game through “any time, any reason” interest rate and fee hikes. Instead, they must disclose, up front, the specific, material reasons for which they will unilaterally change contract terms.
2. **Limiting Retroactive Application of Rate Hikes for Consumers in Good Standing.** H.R. 627 prohibits card issuers from applying “universal default” interest rate hikes retroactively to balances borrowed at a lower rate. As cited above, some issuers still use credit information not related to the account a consumer has with that company, such as a drop in a consumer's credit score, to raise interest rates. While consumers with a perfect payment history with their credit card company are understandably outraged when their interest rate rises for these reasons, the devastating consequences of retroactive application of these increases is equally egregious. Minimum monthly payments rise, sometimes dramatically. The time to pay-off the balance increases, sometimes by many years, while the total cost of the debt skyrockets. H.R. 627 limits these destabilizing impacts by prohibiting the retroactive application of rate hikes not related to the cardholder’s credit card account.

3. **Preventing Credit Card Companies from Gaming Consumer Payments.** H.R. 627 reduces the ability of card companies to play costly games with consumer payments by requiring them to apply payments proportionately to card balances with different interest rates. As stated above, when consumers accept card offers for short-term teaser rates for balance transfers and cash advances and higher rates for other balances, credit card companies apply payments *first* to the lower-rate balance, preventing consumers from paying off higher interest balances and imposing unwarranted and costly finance charges. Issuers refuse to apply *any* portion of a consumer's payment to the higher interest rate balance, preventing consumers from paying down *any* portion of the high-cost balance until the lower interest rate balance is repaid. As a result, balances build up at the much costlier rate and finance charges accrue.
  
4. **Prohibiting Unfair and Hidden Interest Rate Charges on Balances Repaid During the Grace Period.** H.R. 627 prohibits credit card companies from using “double-cycle billing” to charge interest on balances repaid during the grace period. As mentioned above, this practice allows credit card issuers to sap unwarranted finance charges from the wallets of consumers who usually do not carry balances. Although some credit card issuers have disavowed this practice, some still engage in it. This legislation makes clear that a grace period is a grace period.
  
5. **Ending Unfair Late Fees for On-Time Payments.** H.R. 627 ends the classic late-fee gotcha. Consumers who mail their payments well in advance are often socked with a late fee of up to \$40 because of card companies' own processing delays or arbitrary deadlines. The abuse has been exacerbated as credit card companies have shortened the time period in which consumers can make an on-time payment. Other consumers make electronic payments on the due-date, only to be hit with a late fee because they posted their payment five minutes after the issuer's arbitrary deadline on that day. The legislation provides that consumers demonstrating that they have paid their bill at least seven days before the due date are presumed to have paid on time and cannot be charged a late fee. It also sets a single uniform time of no earlier than 5 p.m. local time by which payments must be received on the due date to prevent companies from setting earlier and arbitrary deadlines that result in late fees. Issuers must also mail credit card bills 25 days before the bill is due, instead of the current rule requiring only 14 days, to help ensure that consumers will have enough time to pay.

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

- Consumers will be able to choose not to be allowed to exceed their credit limit
- Credit card companies will not be able to extend credit to borrowers younger than 18.

- Consumers who receive extraordinarily high-cost “subprime” cards would be better protected under H.R. 627. The Board rule permits fees to consume 50 percent of the consumer’s credit line, whereas under H.R. 627 fees cannot be charged to more than 25 percent of the credit line.

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

- Prohibiting the practice of deferring interest rate payments. Deferred interest usually involves an advertised promise such as “no interest for one year,” but the fine print calls for interest to be charged retroactively if the consumer does not fulfill a condition of the deferral agreement, such as paying in full before the end of the deferral period.
- Banning the hair-trigger loss of promotional interest rates. Issuers would not be able to use any reason they wanted to raise a promotional rate during the promotional period, but could only do so if a cardholder was thirty days or more late in paying a bill.
- Prohibiting “universal default” rate increases on future purchases for the year a card is issued. The rule primarily restricts interest rate increases on existing balances, but in this case the rule would prohibit interest rate increases prospectively for the first year a card is issued, because of a supposed problem the cardholder has with another creditor or a drop in the cardholder’s credit score.

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

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

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

## **PART 2. THE NEED FOR THE CONSUMER OVERDRAFT PROTECTION FAIR PRACTICES ACT**

Similarly, the **Consumer Overdraft Protection Fair Practices Act, HR 1456**, addresses a separate set of largely unregulated unfair tricks and traps that also place a consumer's wallet at risk. Instead of deterring the practice of bouncing checks, as they did for decades, over the last 5-10 years, more and more banks have encouraged consumers to bounce checks and other debits, replacing a beneficial back-up system for checking accounts with a system of high-cost, unsolicited overdraft loans that are in effect the banks' version of a usurious payday loan. The costly, and often multiple, fees charged for these overdraft loans drive their customers further into the red. The problem has grown worse as formerly small cash transactions have been substituted by small debit transactions that are approved at point-of-sale even when the bank knows the account shows a negative balance. The costly, and often multiple, fees charged for these overdraft loans drive their customers further into the red.

### **A. INTRODUCTION**

Without asking for their consent, banks and credit unions unilaterally permit most customers to borrow money from the bank by writing a check, withdrawing funds at an ATM, using a debit card at the point of sale, or preauthorizing an electronic payment that exceeds the funds available in a checking account. Instead of rejecting the debit card purchase or ATM withdrawal or returning the check unpaid, most institutions will now cover the overdraft and impose an expensive fee for each transaction.

Consumers do not apply for this form of credit, do not receive information on the cost to borrow bank funds via overdrafts, are not warned when a transaction is about to initiate an overdraft, and are not given the choice of whether to borrow the funds at an exorbitant price or simply cancel the transaction. Banks are permitted by the Federal Reserve to make cash advances through overdraft loans without complying with Truth in Lending cost disclosure rules, denying consumers the ability to make informed decisions about whether to access credit, as well as comparison shop for the lowest cost overdraft program.

Just as payday lenders use the borrower's personal check or debit authorization to insure priority payment, banks use their contractual right of set-off to collect the amount of the overdraft loan and the fee by taking money out of the next deposit into the borrower's checking account. Overdrafts are typically repaid within days, and the flat overdraft fees for very short-term extensions of credit result in outrageous interest rates.

Common banking practices, as confirmed by the FDIC's recent study of overdraft programs, now increase the number of overdrafts rather than minimize them—and can cost the account holder hundreds of dollars in a matter of hours, when they otherwise may have been overdrawn by just a few dollars for a few days or less.

Debit card overdrafts are now the single largest source of overdraft fees and are especially costly for account holders because they carry the same high flat fee but for much smaller loans.

Abusive overdraft loans are costly for everyone, but are most destructive to people who are struggling to meet their financial obligations. For example, the Center for Responsible Lending (CRL) recently found that seniors who depend primarily on Social Security income to cover living expenses pay over \$1 billion in overdraft fees each year.<sup>124</sup> In a system hugely out of balance, our big financial institutions are collecting enormous fees from people who have nothing to spare, making them even less able to meet their obligations.

It has been disheartening to see wealth stripped away from American families by a variety of insidious predatory lending practices over the past decade, and now the very mainstream practice of abusive overdraft lending must be counted among them. Moreover, as the average overdraft fee continues to increase and as debit card transactions become increasingly common, the trend is toward more abuse, not less. Indeed, the most recent survey of the nation's sixteen largest banks found that overdraft fees continue their upward spiral, with the largest fee charged by banks ranging from \$34 at Citibank (up from \$30 just eight months ago) to a maximum \$39 charged by Citizens Bank. The median maximum overdraft fee for the largest banks is now \$35. Only two of the largest banks cap the number of overdraft fees imposed in a single day. Bank of America recently dropped its cap on fees. (See Appendix C, CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices.)

This trend will no doubt continue unless this Committee takes strong action—the need for which has been dramatically underscored by the FDIC's recent survey of the institutions it regulates.

We strongly support HR 1456 as a strong solution to the problem of abusive overdraft lending. This legislation will help stop the abuse, without limiting the ability of financial institutions to provide genuine protection for their customers.

In this section of the testimony:

- We will describe the dysfunctional overdraft lending system that now dominates the market and how it has changed drastically from a model that was once truly just an occasional courtesy. We will report on a survey of the largest banks and their current overdraft fees and practices;
- We will explain that abusive overdraft lending costs \$17.5 billion per year and that nearly half of these fees, \$7.8 billion, come from overdrafts triggered by debit cards at the checkout counter or ATMs—overdrafts that could be prevented with a warning or if the transaction were simply declined;
- We will recommend that Congress pass HR 1456, a solution that will put real protection back into overdraft policy;

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<sup>124</sup> See Leslie Parrish and Peter Smith, *Shredded Security: Overdraft practices drain fees from older Americans*, Center for Responsible Lending (June 18, 2008), available at <http://www.responsiblelending.org/pdfs/shredded-security.pdf> [hereinafter *Shredded Security*].

- And we will urge the Committee to encourage the Federal Reserve Board, currently considering limited new rules related to overdraft loans, to require institutions to obtain account holders' affirmative consent before enrolling them in fee-based overdraft programs for debit card purchases and ATM transactions.

### Abusive Overdraft Lending Systematically Strips Funds from Checking Accounts

Abusive overdraft loans should not be confused with cheaper sources of back-up funds for checking accounts. Under traditional programs that link checking accounts to a savings account or line of credit, which are legitimate money management tools, funds are transferred in increments when the checking account is temporarily overdrawn. Financial institutions have offered such programs for decades. The largest banks charge a median \$10 fee to transfer consumers' funds from savings accounts to cover overdrafts in their checking accounts.

Today, however, banks commonly enroll their checking account holders in a high-cost fee-based system automatically at the time they open a checking account. The FDIC reports that over three-fourths of the banks it surveyed automatically pay overdrafts for a fee and seventy-five percent of those banks automatically enroll their customers in overdraft programs without their permission.<sup>125</sup> If an account dips into a negative balance, the bank routinely covers the overdraft—a change from past practices—paying the shortfall with a loan from the banks' funds. When the account holder makes the next deposit, the bank debits the account in the amount of the loan plus a fee, which now averages \$34.<sup>126</sup> At the largest banks, the median overdraft fee is \$35.

### Overdraft Loans Create a Vicious Cycle of Debt for the Most Vulnerable

The method in which overdraft loans are repaid contributes to the harm they cause consumers. Banks currently treat overdraft loan “fees” as checking account fees under the Truth in Savings Act. As a result, banks can and do use their right of set-off to pay themselves first out of the consumer's next direct deposit of pay or benefits. Consumers caught by overdraft loans do not get affordable installment repayment schedules. The full amount of the overdraft and the fees

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<sup>125</sup> The FDIC Study found that 75 percent of banks surveyed automatically enrolled customers in automated overdraft programs. FDIC Study of Bank Overdraft Programs at iii (Nov. 2008) [hereinafter “FDIC Study”].

<sup>126</sup> Eric Halperin, Lisa James, and Peter Smith, *Debit Card Danger: Banks offer little warning and few choices as customers pay a high price for debit card overdrafts*, Center for Responsible Lending, at 8 (Jan. 25, 2007), available at <http://www.responsiblelending.org/pdfs/Debit-Card-Danger-report.pdf> [hereinafter *Debit Card Danger*]. The FDIC study found that the median fee charged by surveyed institutions was \$27. Our research reflects the average paid by account holders. It is not surprising that it is larger since larger institutions with more customers generally charge higher fees. Government Accountability Office report on bank fees, *Bank Fees: Federal Banking Regulators Could Better Insure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts*, GAO Report 08-291 at 16 (Jan. 2008) (noting larger institutions' average NSF and overdraft fees were higher than smaller institutions').

are due and payable immediately and the bank reserves the right to deduct full payment out of the next deposit of funds into the account.

For low-income account holders who have no cushion of cash in their bank account, repayment of the overdraft and the average \$34 charge is difficult to make up before another debit hits their account, sending them further into the red, triggering another \$34 fee, and accelerating a downward spiral of debt. As discussed below, a small percentage of customers end up paying enormous amounts for overdraft loans, and these consumers tend to be lower-income and minority.

The example of Mary in Appendix B provides a real life illustration of how overdraft loans create a cycle of extremely costly debt. During two months in which she had overdrawn transactions, the fees totaling \$448 themselves created more overdrafts because they were immediately deducted from her next deposit, leading to more fees. See Notes for examples of bank overdraft terms.<sup>127</sup>

### Banks Speed Withdrawals but Not Deposits

In this age of fast-paced banking and electronic bill pay, anyone can temporarily slip into a negative balance. Check 21, passed in 2004, allows banks to debit accounts more quickly, while the rules for how long they can hold deposits before crediting accounts have not been updated in 20 years.

When banks hold deposited local checks until the permitted second business day, a paycheck drawn on a local bank and deposited on Friday afternoon can be held until Tuesday before money is available in the account to cover transactions. Fifth-day availability for deposited non-local checks means consumers may have to wait a whole week for deposits to become available, even when the check is drawn on the bank where it is deposited.

A spokesperson for a large national bank told the Atlanta Journal Constitution that the bank holds some deposits for as long as the law allows, unless the account holder calls and asks for a quicker credit.<sup>128</sup> By treating credits and deposits so differently, banks subject account holders to a heightened risk of overdrafting.

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<sup>127</sup> Examples of bank terms and conditions provisions about repayment of overdrafts:

Bank of America: "If we overdraw your account, you agree to repay us immediately, without notice or demand from us. We may use deposits you or others make to your account to pay overdrafts, fees and other amounts you owe us."

Chase: "If we pay an item or honor your request that overdraws your Account, a deposited item has been returned unpaid, or for any other reason your Account has become overdrawn, you agree to pay the amount of the overdraft together with any fee and accrued interest identified in this Agreement immediately, whether or not you signed or requested the withdrawal or participated in the transaction creating the overdraft."

<sup>128</sup> Peralte C. Paul, *Whose Money is it? Checks Clear Faster than ever, but deposits tend to creep into accounts slowly. Watchdogs want banks to change.* Atlanta Journal Constitution, May 10, 2007.

## Banks Manipulate the Order of Processing Withdrawals to Drive Up Fee Revenue

Financial institutions manipulate the order in which withdrawals are posted in order to trigger more fees. Institutions usually clear the largest transaction first, causing more transactions to overdraw the account. As the example scenarios in Appendix A demonstrates, this practice generates more in overdraft revenues because the institution can charge an overdraft fee for each transaction once the account is below zero. Using the same exact transactions, the bank in Scenario A, which processes transactions chronologically, only generates a single overdraft fee of \$34. The bank in Scenario B, which manipulates transactions by posting larger debits first, generates eight overdraft fees, for a whopping \$272 in fees.

Consumers do not know the order in which items drawn on their account will be presented to their bank and are not likely to know the order in which their bank pays items. Banks bury the disclosures about the order in which they process transactions, and these disclosures provide the banks the widest possible latitude to engage in this behavior.<sup>129</sup> Even the Federal Reserve noted in adopting Truth in Savings regulations in 2005 that consumers who are aware that their account may be overdrawn are not likely to know the number of items that will bounce or the total fees they will be charged.<sup>130</sup>

Banks claim they do customers a favor by paying the largest, and presumably most important, items first to ensure those items get paid. But this argument is disingenuous when a bank has an overdraft loan program, *because the bank pays all of the transactions*, regardless of the order in which they are posted. So no matter what order the transactions are cleared in, all items get paid, and the only difference is how much the customer pays in overdraft fees.

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<sup>129</sup> See, e.g., US Bank's 26-page document, *Terms and Conditions for Deposit Accounts*, effective Feb. 1, 2005, available at [https://fastapp.usbank.com/fastapp/en\\_us/termsAndConditions/TandC/LinkDepositAgreementCurrent.jsp](https://fastapp.usbank.com/fastapp/en_us/termsAndConditions/TandC/LinkDepositAgreementCurrent.jsp) (last visited Mar. 15, 2009): "If we get a batch of such items in a day (checks typically come in batches), and if one, some or all of them would overdraw the account if paid, we can pay or refuse to pay them, in any order, or no order . . . We have all these options each time you might overdraw an account. What we do one time does not make that a rule you can rely on for the future"; Bank of America's 36-page document, *Deposit Agreement and Disclosures*, available at [https://www1.bankofamerica.com/efulfillmentODAO/new\\_window\\_np.cfm?appURL=https://www1.bankofamerica.com/efulfillment/&showdaddoc=91-11-2000ED&daddoc2use=20081101&type=1&view=htm](https://www1.bankofamerica.com/efulfillmentODAO/new_window_np.cfm?appURL=https://www1.bankofamerica.com/efulfillment/&showdaddoc=91-11-2000ED&daddoc2use=20081101&type=1&view=htm) (last visited Mar. 15, 2009): "We may process and post items in any order we choose . . . We may change categories and orders within categories at any time without notice. . . . [S]ome posting orders may result in more insufficient funds items and more fees than other orders. We may choose our processing and posting orders regardless of whether additional fees may result." Wachovia, *Deposit Agreement and Disclosures for Personal Accounts*, effective Feb. 8, 2008, available at [http://www.wachovia.com/personal/online\\_services/disclosure/view/0,,7.00.html](http://www.wachovia.com/personal/online_services/disclosure/view/0,,7.00.html) (last visited Mar. 15, 2009): "Although we generally pay larger items first, we are not obligated to do so and, without prior notice to you, we may change the order in which we generally pay items."

<sup>130</sup> Federal Reserve Board, Final Rule, Regulation DD, Docket No. R-1197, May 19, 2005, p. 4.

CFA's review of the largest banks' account agreements and customer information found that fifteen banks disclose that they pay the largest transactions first or reserve the right to pay withdrawals in the order the bank chooses. There was insufficient information to determine payment order at one bank surveyed. Bank customer agreements typically reserve the bank's right to change the order of processing withdrawals without notice or consent from account holders.

Indeed, the FDIC's recent study found that over half of the large banks surveyed process overdrafts from largest to smallest.<sup>131</sup> The survey further found, not surprisingly, that banks that engage in this abusive practice generate more overdraft fees than those who don't, but they also end up with more uncollectible debt related to overdraft loans.<sup>132</sup>

### Consumer Views on Overdraft Practices

Consumers by a wide margin believe they are treated unfairly when banks permit them to overdraw at the ATM without warning. A 2004 survey poll of a representative sample of 1,000 adult Americans conducted for CFA by Opinion Research Corporation International found that an overwhelming majority (82 percent) of consumers thought permitting overdrafts without any notice at the ATM was unfair, while 63 percent said it was "very unfair." Fewer than one in five (17 percent) people thought it was fair. Consumers think they should be provided the opportunity to affirmatively opt in to overdraft provisions of their checking accounts. In CFA's 2004 ORCI poll, more than twice as many consumers thought it would be unfair for banks to permit overdrafts without obtaining their customers' consent (68 percent) rather than fair (29 percent).

A 2009 CRL survey found that 80 percent of consumers who wanted a choice about overdraft thought that their debit purchases and ATM withdrawals should only be covered for a fee if they affirmatively asked for overdraft coverage for those transactions. But the default arrangement for most institutions continues to be coverage—whether or not the account holder asked for it.

The *Consumer Reports* National Research Center 2009 poll of a nationally representative sample of 679 people found that two thirds of consumers prefer to expressly authorize overdraft coverage, so that there would be no overdraft loan – or fee – until they opted into the service. Likewise, two thirds of consumers said that banks should deny a debit card or ATM transaction if the checking account balance is too low.

Protecting consumers against unauthorized overdraft loans could also benefit banks. A 2006 study by Forrester Research Group documented that consumers are "irked" by overdraft fees. While 65 percent of consumers with no overdraft fees said they were very satisfied with their banks, only 53 percent of consumers charged overdraft fees in the last few months reported being

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<sup>131</sup> FDIC Study at iii (noting that 53.7% of large banks batched processed transactions by size, in order from largest to smallest).

<sup>132</sup> FDIC Study at 62.

very satisfied.<sup>133</sup> By offering contractual overdraft protection by linked savings accounts, low cost lines of credit, and transfers to credit cards, banks can provide real protection at lower cost to consumers and avoid angering a larger number of banking customers.

## B. OVERDRAFT LOANS ARE A FORM OF INVOLUNTARY CREDIT

There is no question that overdrafts loans constitute a form of credit. Overdrafts are credit under the Truth in Lending Act (TILA), which defines “credit” as the right to “incur debt and defer its payment.” See 15 U.S.C. §1602(e). When a bank permits a consumer to use the bank’s funds to pay for an overdraft, and then requires the consumer to repay the bank, it is granting the right to incur a debt and defer its payment until the consumer’s next deposit.

Overdraft or bounce loans are unique in that they are one of the few forms of *involuntary* credit. Banks essentially “cram” these loans on consumers, *i.e.*, they impose this form of credit on consumers who have not requested it. Furthermore, some consumers may not be aware until they overdraw their account that they are accessing a high-cost credit product. This is especially true in the ATM or debit card context, where transactions that would overdraw an account were previously declined and did not incur a fee. The *Consumer Reports* National Research Center poll also found that many consumers do not expect their bank to pay a debit card or ATM transaction that overdraws an account. Forty-eight percent of those polled thought an ATM card would not work if the account balance was too low and another ten percent thought they would not be assessed a fee if the bank allowed the overdraft. Thirty-nine percent of people thought their bank would either deny a debit transaction or allow it to proceed without charging a fee.<sup>134</sup>

Indeed, we can recall only one time that consumers were sent loan products without their affirmative opt-in – when creditors sent unsolicited credit cards to consumers in the 1960s.<sup>135</sup> As a result of the outcry over this practice, Congress stepped in, amending TILA in 1970 to ban unsolicited credit cards.<sup>136</sup> According to the Senate report that accompanied this TILA amendment, unsolicited credit cards encouraged consumers to incur unmanageable debt, and many consumers found them an unwarranted intrusion into their personal life.<sup>137</sup> These same problems cited by this Senate report nearly 40 years ago hold true today for unsolicited overdraft loans – they cause severe financial distress and represent an intrusion on the lives of consumers.

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<sup>133</sup> CUNA News: “Consumers ignore ATM fees, get irked at overdraft fees,” January 17, 2006.

<sup>134</sup> *Consumer Reports* National Research Center, Financial Regulation Poll, as filed with the Federal Reserve Board in Reg E Docket R-1343, March 12, 2009.

<sup>135</sup> Note that a “stickiness” of default options was observed with respect to unsolicited credit cards, which is the same with unsolicited overdraft loans. When unsolicited credit cards were permitted, very few consumers opted out – only 1% returned the card. However, when prospective customers were asked whether they wanted to receive a card, only 0.7% said they would. Jack Metcalfe, *Who Needs Money*, New York Sunday News, Nov. 24, 1968, reprinted in 115 Cong. Rec. 1947, 1951 (Jan. 23, 1969).

<sup>136</sup> Pub. L. No. 91-508, 84 Stat. 1126-27 (Oct. 26, 1970).

<sup>137</sup> S. Rep. No. 91-739, at 2-44 (1970).

Note that in the case of unsolicited credit cards, the consumer at least has to affirmatively and knowingly take action to *use* the credit card, by making a purchase or taking a cash advance. In the case of overdraft loans, the consumer not only receives credit without requesting it, the consumer often unknowingly and involuntarily *uses* that credit when she triggers an overdraft, especially in the debit card situation where many consumers don't realize they can overdraw their accounts.

Thus, overdraft loans represent an even worse problem than unsolicited credit cards did nearly 40 years ago. H.R. 1456 would prohibit this “cramming” of overdraft loans on consumers by requiring banks to obtain specific written consumer consent before adding this feature to a bank account.

### **C. THE FEDERAL RESERVE BOARD HAS FAILED TO PROTECT CONSUMERS FROM ABUSIVE OVERDRAFT LOANS**

As discussed above, overdrafts are clearly “credit” under the federal Truth in Lending Act (TILA). The reason that overdraft loan programs do not require TILA disclosures is an exemption created by the Fed. Regulation Z, which implements TILA, excludes overdraft fees from the definition of a “finance charge.” This exemption, written in 1969, was originally designed to exclude from TILA coverage the traditional banker’s courtesy of occasionally paying overdrafts on an ad-hoc basis as a customer accommodation. However, banks exploited this exemption as a gaping loophole, creating and promoting predatory credit, extended on a routine basis without adequate disclosure – contrary to the clear statutory language and intent of TILA. As a result, H.R. 1456 would amend TILA itself to ensure that institutions no longer benefit from a loophole to exploit account holders.

In general, the fees for overdraft loans translate into APRs that are triple-digit or even higher. For example, consider a \$100 overdraft loan that is repaid in two weeks, for which the bank charges a \$20 fee. A comparable payday loan would have to disclose an APR of 520%. Furthermore, most overdraft loans are paid much more quickly than two weeks – sometimes in a matter of days or hours – and sometimes the loan is only for a few dollars.

Instead of requiring TILA disclosures, the Fed chose to regulate overdraft loans under the less effective Truth in Savings Act (TISA), simply requiring disclosure of the fee and a running tally. Regulation DD, 12 C.F.R. Part 230. TISA disclosures do not reduce or eliminate the most serious abuses of overdraft loans.

The failure of the Fed to require TILA disclosures for overdraft loans undermines the statute’s key purpose of strengthening “competition among the various financial institutions and other firms engaged in the extension of consumer credit.”<sup>138</sup> Without the uniform disclosure of the APR required by TILA, consumers have no way to compare overdraft loans to the cost of an overdraft line of credit or transfer from savings. Under the Fed’s rules, the disclosed APR for a

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<sup>138</sup> 15 U.S.C. § 1601(a)

typical payday loan is 391% to 443%<sup>139</sup> but for an overdraft loan program the lender may disclose under TISA that the account is actually earning interest! Without apples to apples comparisons, there is no competition to reduce the cost of any of these products.

If overdraft loans are to be permitted at all, banks must be required to make TILA disclosures. H.R. 1456 would fulfill that need by requiring banks to make the same APR disclosures required of credit card lenders under TILA. This includes a disclosure of the “effective” or fee-inclusive APR, which is an APR that includes the impact of fees on the price of credit.

However, in December 2008, the Fed eliminated the effective APR disclosure for credit cards and other forms of open-end credit. Among other problems, this change means that the sky high APRs for overdraft loans would not be disclosed even if overdraft loans are brought into TILA’s scope of coverage. That is because the “periodic APR” for these loans is 0% – it’s the flat fee for the overdraft that makes this form of lending so expensive. Only the effective or fee-inclusive APR that the Fed eliminated would include this type of flat fee in its calculation.

We recommend that H.R. 1456 be amended to require a special APR disclosure for overdraft loans. This APR will be calculated similarly to how an APR is calculated for a payday loan. The special overdraft APR will be included on any monthly statements in which an overdraft fee is assessed. In addition, we recommend that sample APRs be provided to consumers when they are being asked to opt-in to an overdraft loan program, so that consumers understand the exorbitant costs of using overdrafts as a source of credit before they sign on the dotted line.

#### **D. OVERDRAFT LENDING COSTS AMERICANS \$17.5 BILLION IN ABUSIVE AND LARGELY PREVENTABLE FEES**

Marketed as “overdraft protection,” in actuality, abusive overdraft lending protects only the banks’ ability to maximize fees while jeopardizing the financial stability of many of its customers. Rather than competing by offering lower cost, truly beneficial overdraft products and services, many financial institutions are hiding behind a smokescreen of misleading terms and opaque practices that promote costly overdrafts.

Americans pay more in abusive overdraft loan fees than the amount of the loans themselves—\$17.5 billion in fees for \$15.8 billion in credit extended.<sup>140</sup> This makes crystal clear the degree to which the cost of this so-called service is out of line with any benefit.

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<sup>139</sup> Keith Ernst, et al., *Quantifying the Economic Cost of Predatory Payday Lending*, Center for Responsible Lending (December 18, 2003), at 3.

<sup>140</sup> Eric Halperin and Peter Smith, *Out of Balance: Consumers pay \$17.5 billion per year in fees for abusive overdraft loans*, Center for Responsible Lending, at 9 (June 2007), available at <http://www.responsiblelending.org/issues/overdraft/reports/page.jsp?itemID=33341925> [hereinafter *Out of Balance*]. CRL analyzed 18 months of bank account transactions from participants in Lightspeed Research’s Ultimate Consumer Panel, from January 2005 to June 2006. For further discussion of CRL’s database and methodology, see *Out of Balance* at 13-14.

High fees, coupled with small overdrafts, results in consumers paying more to borrow from banks than the banks extended as credit.

**Figure 1. Consumers pay back more in overdraft fees than total loans extended**

Overdraft loan fees now make up 69 percent of all overdraft-related fees, while traditional NSF fees—generated when the transaction is denied—make up only 31 percent.<sup>141</sup> Abusive overdraft loans, once the exception, are now the rule.

#### Small Dollar Overdrafts Trigger Steep Fees

The FDIC’s ground-breaking report on bank overdraft loan programs, fees and practices was based on a detailed study of 462 FDIC-supervised banks and data on overdraft transactions from 39 banks. The typical debit card purchase overdraft was only \$20 but cost an average \$27 fee at FDIC banks.

If repaid in two weeks, that overdraft costs 3,520 percent APR. The typical \$60 ATM withdrawal on insufficient funds costs 1,173 percent APR. The median size check that overdraws an account is \$66, an APR of 1,067 percent.<sup>142</sup> If the bank adds a “sustained overdraft fee” or requires repayment in less than two weeks, the APRs on these loans are even higher. Furthermore, because consumers often use their debit cards several times per day, multiple fees will be charged when an account is overdrawn.

A recent survey of the nation’s largest banks confirms that not only are overdraft fees becoming more common, but the fee per transaction is getting larger. The maximum overdraft fee at this sample of banks is now \$39, while the median fee is \$35. Half of the largest banks use tiered fee schedules, with fees rapidly escalating when consumers incur more than a few overdrafts over a one-year period. US Bank charges \$19 for the first overdraft, \$35 for the second through fourth, and \$37.50 thereafter. Fifth Third Bank switched to tiered fees in the last year, now charging from \$25 to \$37 per overdraft. Bank of America terminated its tiered fee structure and now charges \$35 for each incidence.

Eight of the sixteen largest banks add sustained overdraft fees when consumers are unable to pay the overdraft and fee within a few days. On top of already high initial overdraft fees, Citizens Bank and SunTrust add a \$35 fee while Chase charges another \$12.50 to Arizona consumers



<sup>141</sup> *Out of Balance* at 10.

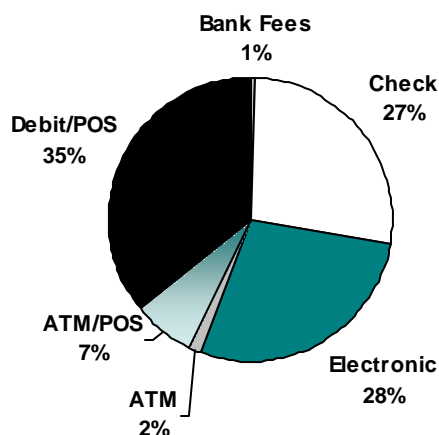
<sup>142</sup> FDIC Study at v.

when an overdraft goes unpaid five days. When initial overdraft fees and sustained overdraft fees are combined for overdrafts unpaid after seven days, consumers can be charged as much as \$74 at Citizens Bank for a single overdraft. The combined cost at SunTrust is \$70 and at National City \$68. Only two of the largest banks limit the number of overdraft fees imposed in one day. Bank of America limited overdraft fees to seven per day but removed its cap in February 2009.

Banks Turn Debit Cards into High Cost “Credit Cards” When Overdrafts Permitted

Today, banks swipe a large portion of these fees when their account holders swipe debit cards at ATMs and checkout counters. A 2007 CRL report found, and the FDIC study recently confirmed, that debit card purchases are the most common trigger of overdraft fees.<sup>143</sup>

**Figure 2. Identified Overdraft Fee Triggers**



When debit cards first came into common use, they promised the convenience of a credit card without the cost, because debit card users were required to have the funds in their account to cover their purchase or withdraw cash. As recently as 2004, 80 percent of banks still declined ATM and debit card transactions without charging a fee when account holders did not have sufficient funds in their account.<sup>144</sup> But banks now

routinely authorize payments or cash withdrawals when customers do not have enough money in their account to cover the transaction, so debit cards end up being very costly for many account holders.

In addition to being the most common trigger, these debit card overdrafts are more costly than overdrafts caused by paper checks or ACH electronic payments. The average overdraft loan triggered by a debit card purchase is less than \$17 and is paid back in fewer than five days.<sup>145</sup>

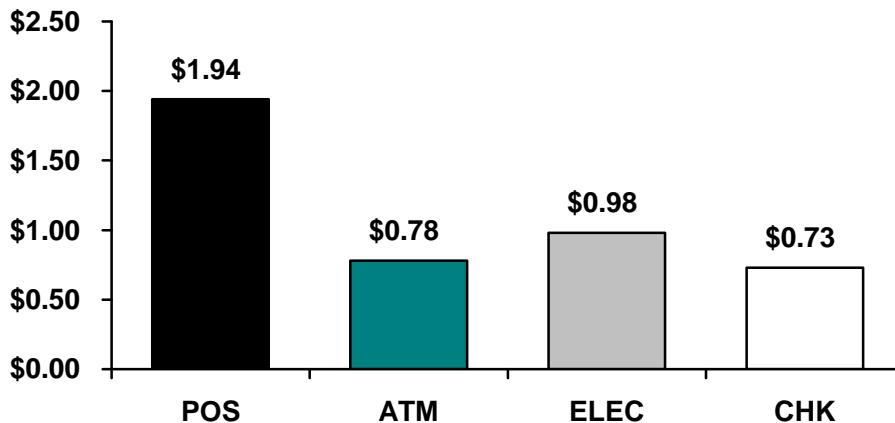
<sup>143</sup> *Debit Card Danger*. See also FDIC Study of Bank Overdraft Programs (Nov. 2008) (finding 41 percent of NSF-related transactions were triggered by point-of-sale/debit and another 7.8 percent by ATM transactions).

<sup>144</sup> Mark Fusaro, *Are “Bounced Check Loans” Really Loans?*, note 4, at 6 (Feb. 2007), available at <http://personal.ecu.edu/fusarom/fusarobpintentional.pdf> (last visited Mar. 15, 2009). See also Sujit Chakravorti and Timothy McHugh, *Why Do We Use So Many Checks?* Economic Perspectives, 3rd Quarter 2002, Federal Reserve Bank of Chicago, 44, 48 (“When using debit cards, consumers cannot overdraw their accounts unless previous credit lines have been established.”).

<sup>145</sup> *Debit Card Danger* at 8.

Given the average \$34 fee, this means account holders pay \$1.94 in fees for every one dollar borrowed to cover a debit card point-of-sale overdraft.<sup>146</sup>

**Figure 3: Fees paid per dollar borrowed for overdraft loans, by trigger type**



Taken as a whole, debit card and ATM swipes, which could easily be denied for no fee, cost Americans \$7.8 billion per year in abusive overdraft lending fees.<sup>147</sup>

Banks and credit unions could prevent every dollar of these debit card overdraft fee charges by simply notifying account holders when they are about to overdraw their accounts or by declining a transaction when there are insufficient funds available, as they did in the past. Indeed, consumers would appreciate the warning: 80 percent of consumers surveyed would rather have their debit transaction denied than covered for a fee, whether that transaction is \$5 or \$40.<sup>148</sup> Institutions often claim that denial at the point of sale or ATM is not feasible, but it would be

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Median values by type of overdraft:

|      | Fee Amount | Txn Amount | Loan Amount | Days | Fee per Dollar Borrowed |
|------|------------|------------|-------------|------|-------------------------|
| POS  | \$34.00    | \$20.00    | \$16.46     | 5    | \$1.94                  |
| ATM  | \$34.00    | \$40.00    | \$40.00     | 3    | \$0.78                  |
| ELEC | \$34.00    | \$29.14    | \$27.95     | 4    | \$0.98                  |
| CHK  | \$34.00    | \$60.00    | \$41.38     | 2    | \$0.73                  |

<sup>146</sup> *Id.*

<sup>147</sup> *See Out of Balance.*

<sup>148</sup> Leslie Parrish, *Consumers Want Informed Choice on Overdraft Fees and Banking Options*, CRL Research Brief (Apr. 16, 2008), available at <http://www.responsiblelending.org/pdfs/final-caravan-survey-4-16-08.pdf> [hereinafter CRL Research Brief].

surprising—shocking, in fact—if banks couldn’t accomplish now technologically what they could in 2004.<sup>149</sup>

Furthermore, 7.9 percent of banks in the FDIC survey reported that they did inform customers at a debit card point of sale that funds were insufficient before transactions were completed, offering the customers an opportunity to cancel and avoid a fee, and 23.5 percent did the same at ATMs. It’s difficult to believe that these banks have some sort of advanced technology unavailable to other banks.

Absent meaningful regulatory reform, banks will only increase their profits from overdraft fees as debit card transactions continue to skyrocket.<sup>150</sup> Debit card transactions will not only continue to grow as a percentage of all bank transactions, but they will continue to provide banks more transactions *overall* as more account holders use them in place of cash for small transactions.

### Consumers Trapped in Overdraft Loans Can Least Afford Astronomical Fees

The FDIC examined individual transaction information from 39 banks to provide a snapshot of customers who overdrew their accounts on 22.5 million transactions. Nine percent of customers had ten or more insufficient fund transactions in one year. Consumers who overdrew ten to nineteen times in one year paid \$451 in fees, while consumers who overdrew twenty times or more paid \$1,610 in fees per year.<sup>151</sup>

Unfortunately, abusive overdraft fees have the greatest impact on those who can least afford them. Two CRL surveys, conducted in 2006 and 2008, found that account holders who are repeatedly charged abusive overdraft loan fees were more likely to be lower income, single, and non-white.<sup>152</sup> The FDIC study also found that customers living in low-income areas carry the brunt of overdraft fees.<sup>153</sup> CFA conducted a national opinion poll in 2004 which found that 28 percent of consumers say they overdraw their accounts. Consumers who stated they overdraw their accounts and are most likely to pay overdraft and bounced check fees were moderate-income consumers with household incomes of \$25,000 to \$50,000 (37 percent). Those 25 to 44

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<sup>149</sup> In fact, CRL’s affiliate, Self-Help Credit Union, denies all debit and ATM transactions it processes real-time if the account holder lacks sufficient funds and charges no fee even if the transaction is inadvertently paid.

<sup>150</sup> Debit card transactions are increasing at a rate of 17.5 percent per year, while check payments are decreasing 6.4 percent annually. 2007 Federal Reserve Payments Study, Financial Services Policy Committee, *Federal Reserve Study Shows That More Than Two-Thirds of Noncash Payments Are Now Electronic* (Dec. 10, 2007), available at <http://www.federalreserve.gov/newsevents/press/other/20071210a.htm> (last visited Mar. 15, 2009).

<sup>151</sup> FDIC Study. *Id.*

<sup>152</sup> CRL Research Brief.

<sup>153</sup> FDIC Study at v. It further found that account holders who overdrew their accounts more than four times per year paid 93.4 percent of all overdraft fees. *Id.*

years of age (36 percent) and African Americans (45 percent) were most likely to have bounced checks.<sup>154</sup>

Overdraft fees strip funds from Americans of all ages, but research indicates they hit America's oldest and youngest checking account holders—often the least financially stable—especially hard. Older Americans aged 55 and over pay \$4.5 billion of the \$17.5 billion total overdraft fees paid annually,<sup>155</sup> an especially alarming figure given that one in four retirees has no savings of any kind.<sup>156</sup> Those heavily dependent on Social Security pay nearly \$1 billion,<sup>157</sup> while those entirely dependent on Social Security pay over \$500 million.<sup>158</sup>

Appendix B illustrates a real-life case study of one Social Security recipient's checking account activity. Tracking two months of activity, the study demonstrates how much better off she would have been with an overdraft line of credit – or even no overdraft coverage at all – than with the fee-based overdraft coverage she was subjected to. Her account balance was \$18 at the end of the two months; with an overdraft line of credit, it would have been \$420.

At the other end of the age spectrum, young adults who earn relatively little as students or new members of the workforce pay nearly \$1 billion per year in overdraft fees.<sup>159</sup> Because they are far more likely to use a debit card for small transactions than older adults,<sup>160</sup> they pay \$3 in fees for every \$1 borrowed for debit card overdrafts.<sup>161</sup> The situation is exacerbated by deals banks make with universities to provide school ID cards that double as debit cards. Banks pay the

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<sup>154</sup> ORCI Poll for Consumer Federation of America, 2004.

<sup>155</sup> See *Shredded Security*.

<sup>156</sup> *Id.* at 4 (citing 2008 Retirement Confidence Survey, Employee Benefit Research Institute (April 2008) finding that 28 percent of retirees have no savings). *Shredded Security* also notes that even those who do have savings are increasingly spending it on rising healthcare costs (citing Paul Fronstin, *Savings Needed to Fund Health Insurance and Health Care Expenses in Retirement*, Employee Benefit Research Institute (July 2006), projecting that retired couples will need between \$300,000 and \$550,000 to cover health expenses such as long-term care).

<sup>157</sup> *Shredded Security* at 6, Table 1. “Heavily dependent” was defined as recipients who depended on Social Security for at least 50 percent of their total income.

<sup>158</sup> *Id.*

<sup>159</sup> See Leslie Parrish and Peter Smith, *Billion Dollar Deal: Banks swipe fees as young adults swipe debit cards, colleges play along*, Center for Responsible Lending, at 1 (Sept. 24, 2007) [hereinafter *Billion Dollar Deal*], available at <http://www.responsiblelending.org/pdfs/billion-dollar-deal.pdf>.

<sup>160</sup> Seven out of ten young adults would use a debit card for purchases costing less than \$2. *Id.* (citing Visa USA Generation P Survey, conducted July 24-27, 2006. Findings and discussion at <http://corporate.visa.com/md/nr/press638.jsp> (last visited Mar. 15, 2009)).

<sup>161</sup> *Billion Dollar Deal*.

partner school for exclusive access to the student population and sometimes even split the fee revenue they collect on debit card transactions with the university.<sup>162</sup>

### Unemployment Benefit Prepaid Debit Cards Permit Overdrafts

Most recently, our nation's growing unemployed population is being subjected to overdraft fees without their consent through the very cards to which their unemployment benefits are issued. We were appalled to learn that the debit cards to which many states' unemployment benefits are issued come with automatic fee-based overdraft coverage that costs the unemployed user as much as \$17 or more per overdraft transaction.<sup>163</sup> The result, of course, is that the next benefit payment they receive from the government will be automatically reduced by the amount by which they have already overdrawn the card, plus \$17 for each overdraft transaction. The absurdity of this arrangement and its impact on the most vulnerable—an arrangement effectively blessed by the states that forge these agreements with the banks issuing the cards—goes beyond what even our most cynical imaginations could have composed.

#### **E. HR 1456: PUTTING THE PROTECTION BACK INTO OVERDRAFT POLICY**

HR 1456, the Consumer Overdraft Protection Fair Practices Act, would not affect the real overdraft protection programs at banks. It would only prevent abuses created by the relatively new system of unauthorized usurious lending that is premised on generating fee revenue rather than protecting the funds of account holders.

HR 1456 would put the protection back into overdraft policy by requiring financial institutions to fully inform account holders of the costs of fee-based overdraft systems, including their astronomical interest rates. Account holders would have to give specific written consent in order for financial institutions to enroll them in such a costly and problematic system. Banks and credit unions would have to warn account holders before making them a high-cost loan for an electronic transaction and permit them to choose another payment option that will not cause an overdraft.

The bill would also prohibit manipulation of account activity if the result is to increase overdrafts. This would mean no debiting accounts with the highest dollar charge first in order to

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<sup>162</sup> *Id.* at 7 (citing *U.S. Bank Pays Campus for Access to Students*, Milwaukee Journal Sentinel, June 18, 2007 (noting the agreement between US Bank and the University of Wisconsin at Oshkosh prohibits all financial institutions other than US Bank and the college's own credit union from locating ATMs on campus); Amy Milshtein, *In the Cards*, College Planning & Management (Dec. 2005) (noting the fee-sharing deal Higher One has with partner universities)).

<sup>163</sup> See AP Impact: Jobless Hit with Bank Fees on Benefits, Christopher Leonard, AP Business Writer (Feb. 20, 2009) available at [http://news.yahoo.com/s/ap/20090220/ap\\_on\\_bi\\_ge/bank\\_fees\\_jobless\\_benefits](http://news.yahoo.com/s/ap/20090220/ap_on_bi_ge/bank_fees_jobless_benefits); see disclosure of the \$17 overdraft fee at Oregon.gov, [http://www.oregon.gov/EMPLOY/UI/ui\\_payment\\_options.shtml](http://www.oregon.gov/EMPLOY/UI/ui_payment_options.shtml), and in a fact sheet issued by Ohio Job and Family Services promoting the card at [http://jfs.ohio.gov/ouc/ReliaCard\\_FactSheet.pdf](http://jfs.ohio.gov/ouc/ReliaCard_FactSheet.pdf).

increase the number of overdraft fees an account holder is charged. No holding deposits before crediting accounts in order to create a negative balance and charge an overdraft fee. And no authorizing debit and ATM transactions without allowing an account holder to cancel the transaction—itsself another manipulation that increases overdrafts.

HR 1456 would also make sure that consumers understand how expensive overdraft loans are as a source of credit by requiring Truth in Lending disclosures. With the simple fix discussed above, the bill will allow consumers to compare the high cost of overdraft loans with other sources of short term credit.

HR 1456 does not cap bank overdraft fees. While it is reasonable to expect banks to lower fees if they have to give clear cost disclosures and persuade consumers to sign up for this credit product, consumers would benefit from limiting the cost of these high cost loans as proposed in S. 500 to a 36 percent FAIR annual cap. Bank overdraft loans are parallel to payday lending in that the high interest rates and short repayment time often trap consumers in a cycle of debt. Consumers should not have to pay triple digit interest rates for either form of credit.

Banks should also be required to provide overdraft loans subject to a contract that clearly spells out the types of transactions that will be covered, limits on the amount of overdraft coverage provided, the repayment schedule for extensions of credit via overdraft, and other terms and conditions that apply to this transaction. Banks currently include account agreement fine print that leave consumers in a quandary over when and if a particular transaction will be covered. Some bank account terms and conditions state that an overdraft and its fee are due and payable without notice or demand from the bank.

The protections in HR 1456 should apply to prepaid debit cards, such as the cards used to deliver unemployment benefits or cards that function as “bank accounts” for the unbanked. Failure to protect all consumers from unauthorized and unfair overdrafts adds to the two-track financial services market, where banked consumers and unbanked (usually lower-income) consumers do not benefit from the same set of rules.<sup>164</sup>

These protections are a simple matter of fairness and common sense. Current practices defeat the ability of consumers to assert meaningful control over their financial affairs and must be stopped. Banks and credit unions must be required to compete fairly, based not on smokescreens and manipulation, but on offering beneficial products and services at a reasonable price and with fair repayment terms.

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<sup>164</sup> SVC overdraft loan fees are extremely expensive. See Testimony, Jean Ann Fox, CFA, Subcommittee on Social Security, Ways and Means Committee, “Hearing on Protecting Social Security Beneficiaries from Predatory Lending and Other Harmful Financial Institution Practices,” June 24, 2008. [http://www.consumerfed.org/pdfs/Jean\\_Ann\\_Fox\\_Testimony\\_Ways\\_and\\_Means\\_Social\\_Security\\_6-24-08.pdf](http://www.consumerfed.org/pdfs/Jean_Ann_Fox_Testimony_Ways_and_Means_Social_Security_6-24-08.pdf)

## F. THE FED'S PROPOSED RULES: ONLY REQUIRING "OPT-IN" WILL CHANGE THE STATUS QUO

The Federal Reserve has proposed new rules that put forth two very different alternatives for addressing overdraft practices on debit card purchases and ATM withdrawals—

- a. The first alternative would require institutions to allow account holders to opt out of overdraft coverage for these types of transactions.
- b. The second, **far stronger alternative** would require institutions to obtain account holders' affirmative consent, or opt-in, before covering their debit card purchases and ATM transactions in exchange for an overdraft fee.

Only the second alternative would mark significant process toward curbing abusive overdraft practices.

With either alternative the Fed chooses, it will effectively be determining what the default arrangement will be. If it chooses only to require the opt-out alternative, the default will be that account holders continue to be enrolled in the most expensive overdraft option that their bank or credit union offers. If the Fed chooses the opt-in alternative, the default will be that debit card purchases and ATM transactions will be denied, and no overdraft fee incurred, when the customer lacks sufficient funds.

Because scores of behavioral economics research has shown that individuals do not tend to change the default, **it is critical that the Federal Reserve get the default right.**<sup>165</sup> The default arrangement should be the one that does not cause account holders more harm than benefit and that best reflects consumer preferences.

As the facts presented in this testimony have unequivocally demonstrated, fee-based overdraft coverage causes account holders more harm than benefit, and they would prefer that their debit card transaction be denied rather than covered for an overdraft fee. The right arrangement, then, is **opt-in** – no fee-based overdraft coverage for debit card purchases and ATM transactions unless the account holder affirmatively chooses it.

The Federal Reserve's proposed rule, regardless of which alternative it chooses, is already substantially weaker than the provisions of H.R. 1456. Not only does the Fed proposal address only debit card purchases and ATM transactions instead of all transactions, but it also does not recognize that overdrafts are extensions of credit that should require Truth in Lending disclosures, nor does it prohibit manipulating the clearing of transactions to maximize overdraft fees.

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<sup>165</sup> For more on why opt-in is the right default arrangement, *see* Comments of the Center for Responsible Lending to the Federal Reserve System, OTS and NCUA on Proposed Rule Regarding Unfair or Deceptive Acts or Practices – Overdraft Practices, Docket No. R-1314, at 10 and following (Aug. 4, 2008), *available at* <http://www.responsiblelending.org/pdfs/overdraft-comments-udap-final-as-submitted-w-appendices-080408-2.pdf>.

In reality, an opt-out regime could even make the current situation worse—it could create the impression that account holders have been given a fair choice about overdraft, when in reality there is little possibility that account holders will receive a meaningful opportunity to get out of these abusive and expensive programs.

We urge the members of this Committee to weigh in with the Fed and urge it to select the only alternative that would provide additional meaningful protections to account holders – **opt-in**.

### CONCLUSION

The **Credit Cardholders Bill of Rights, H.R. 627**, curbs some of the most arbitrary, abusive, and unfair credit card lending practices that trap consumers in a cycle of costly debt, such as sharply escalating “universal default” interest rates that can double some cardholders monthly payments overnight. It passed the House in 2008 on an overwhelming 312-112 vote. Although the Federal Reserve and other regulators agreed that action was needed and later in the year approved similar regulations, the agencies unwisely stayed compliance until July 2010. Enact HR 627 now.

Today, as many American families struggle to meet daily obligations, the last thing they need is to be surprised by high-cost credit to which they never expressly consented. HR 1456 would address at least three central problems with fee-based overdraft loans: (i) institutions are not required to provide with any *clarity* the terms under which they are extended; (ii) institutions are not required to obtain account holders’ *consent* before extending them; and (iii) institutions maximize their *cost* to account holders by employing an array of unfair practices. We urge this Committee to reverse the current trend toward even greater overdraft abuses by supporting HR 1456.

Swift enactment of both of these bills is necessary to protect millions of consumers from unjustified and abusive loan practices that are putting them at financial risk and draining their income at a time of great economic uncertainty. We look forward to your questions.

**Attached: Appendices A, B and C**

## APPENDIX A

For an illustration of how the practice of clearing checks and debits from the largest dollar amount to the smallest could play out, assume an account holder has \$750 in her checking account. Before she realizes she is not covered, she pays some bills and makes some small dollar purchases, putting her \$143 in the negative.

The order in which these payments clear her checking account makes a big difference in the cost of that shortfall. If the payments were presented to the financial institution on the same day, in the order in Scenario A below, and if they were cleared in the order they were presented, she would be charged like this:

### Scenario A: Chronological Ordering of Charges

| <i>Transaction</i>                | <i>Charge</i> | <i>Account Balance</i> | <i>Average Overdraft Fee</i> |
|-----------------------------------|---------------|------------------------|------------------------------|
|                                   |               | 750                    |                              |
| Credit card payment – ACH         | 90            | 660                    |                              |
| Water bill - check                | 30            | 630                    |                              |
| Groceries purchase – debit card   | 65            | 565                    |                              |
| Gas purchase – debit card         | 25            | 540                    |                              |
| Lunch purchase – debit card       | 10            | 530                    |                              |
| Drugstore purchase – debit card   | 15            | 515                    |                              |
| Family gym fees– check            | 40            | 475                    |                              |
| Coffee purchase - debit           | 8             | 467                    |                              |
| Bookstore purchase – debit card   | 10            | 457                    |                              |
| Rent – check                      | 600           | (143)                  | \$34                         |
| <b>TOTAL OVERDRAFT LOANS</b>      |               | <b>\$(143)</b>         |                              |
| <b>TOTAL OVERDRAFT FEES</b>       |               |                        | <b>\$34</b>                  |
| <b>Balance with fees deducted</b> |               | <b>\$(177)</b>         |                              |

On the other hand, if the payments were cleared from the largest to the smallest, the amount by which her account was overdrawn would remain the same, but the charges would be significantly higher.

### Scenario B: High-dollar Ordering of Charges

| <i>Transaction</i>                | <i>Charge</i> | <i>Account Balance</i> | <i>Average Overdraft Fee</i> |
|-----------------------------------|---------------|------------------------|------------------------------|
|                                   |               | 750                    |                              |
| Rent – check                      | 600           | 150                    |                              |
| Credit card payment – ACH         | 90            | 60                     |                              |
| Groceries purchase – debit card   | 65            | (5)                    | 34                           |
| Family gym fees – check           | 40            | (45)                   | 34                           |
| Water bill – check                | 30            | (75)                   | 34                           |
| Gas purchase – debit card         | 25            | (100)                  | 34                           |
| Drugstore purchase – debit card   | 15            | (115)                  | 34                           |
| Lunch purchase – debit card       | 10            | (125)                  | 34                           |
| Bookstore purchase – debit card   | 10            | (135)                  | 34                           |
| Coffee purchase – debit card      | 8             | (143)                  | 34                           |
| <b>TOTAL OVERDRAFT LOANS</b>      |               | <b>\$(143)</b>         |                              |
| <b>TOTAL OVERDRAFT FEES</b>       |               |                        | <b>\$272</b>                 |
| <b>Balance with fees deducted</b> |               | <b>\$(415)</b>         |                              |

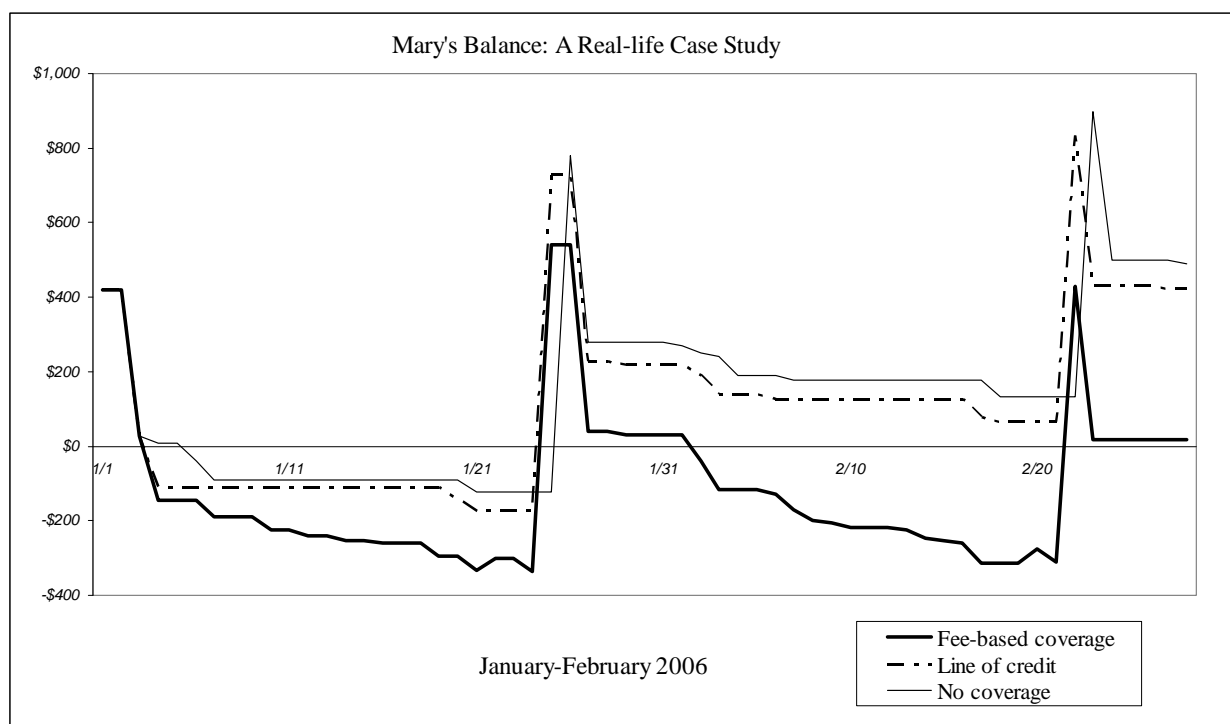
Banks and credit unions claim that their overdraft programs are providing customers a service—protection from returned check fees. But this argument is disingenuous, because in either scenario above, all the transactions are paid. The only difference is that in Scenario B, the bank or credit union increases their fee income by manipulating the order in which they clear the payments.

Of course, if the bank customer had no overdraft program in place at all, her rent would likely be paid late. But even if her landlord charged her a late fee of \$30 (five percent of the rent) and her bank charged an NSF of \$20, for a total of \$50, she would still come out better than she would under Scenario B, which cost her \$272.

## APPENDIX B

### REAL-LIFE CASE STUDY: A Social Security Recipient's Experience with Overdraft Fees

The harm of fee-based overdraft programs dramatically outweighs their potential benefits—a point well illustrated by the following case study. In CRL's recent report on the impact of overdraft fees on older Americans, it graphed two months of actual checking account activity of one panelist from its database, whom the report calls Mary. Mary is an older American entirely dependent on Social Security for her income. It also graphed what her activity would have been with an overdraft line of credit. It later added a third scenario to the graph: no fee-based coverage at all, reflected in the following graph:



During January and February of 2006, Mary overdrew her account several times and was charged \$448 in overdraft fees. At the end of February, she had \$18.48 in her account. She was trapped in a destructive cycle, using the bulk of her monthly income to repay costly overdraft fees.

With an overdraft line of credit at 18 percent, after two months, Mary would have paid about \$1 in total fees for her overdrafts and would have had \$420 in the bank.<sup>166</sup>

<sup>166</sup> *Shredded Security* at 9-10.

Critically, *even if Mary had had no overdraft coverage at all*, she would have been better off than she was with fee-based overdraft. Five of her transactions, totaling \$242, would have been denied—two point-of-sale transactions and three electronic transactions. She would have been charged no fee for the two point-of-sale transactions. She may or may not have been charged an NSF fee for each of the three denied electronic transactions. She also may have been charged late fees if any of the electronic transactions were bills. Assuming, conservatively, that she was charged an NSF fee and a late fee for each of the three transactions, as the chart illustrates, her ending balance still would have been \$489—plenty enough to cover the value of the denied transactions.

Industry's common defense of fee-based overdraft is that it protects account holders from having important payments, like utility bills, bounce. But with fee-based coverage, Mary's utility payments in both January and February were denied *anyway* because she had already overdrawn her account by more than \$300 each time—*largely due to overdraft fees*. With no overdraft coverage at all, while her January utility payment would have been denied, she would have had the money to pay her entire outstanding utility balance in February.

Mary's case demonstrates that while struggling account holders with no overdraft coverage may pay some bills late, they are still better able to pay bills eventually than they would be with fee-based coverage. And late fees they may incur from routine vendors, like utility and phone companies, do not have significant consequences so long as the bills due not remain unpaid for a substantial period of time. Furthermore, with the exception of credit card lenders, many companies do not even charge late fees unless a consumer is over 15 or 30 days late. Typically, then, the potential consequences of late fees are rarely as destructive as the repeat overdraft fees charged to those who pay the majority of these fees.

In addition, Mary's situation illustrates a problem common among the repeat overdrafters who pay the vast majority of the fees: Overdraft fees simply beget more overdraft fees. Not only is there no benefit to the account holder from covering certain types of transactions (debit point-of-sale and ATM), but even when there may be benefit from having a single transaction covered, policymakers must balance this benefit against the subsequent costs to account holders beyond that one transaction—specifically against the increased likelihood that the account holder will pay additional overdraft fees for transactions that carry no cost when denied, and be unable to meet future obligations.

Ultimately, fee-based overdraft coverage prevents account holders from being able to meet obligations they otherwise would have been able to meet. This reality makes it impossible to justify fee-based overdraft as a program that causes account holders more benefit than harm.

## APPENDIX C

### CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices

Consumer Federation of America surveyed the sixteen largest banks providing customer deposit accounts to determine overdraft fees and practices. This review updates a survey for CFA's comments filed with the Federal Reserve Board in a regulatory docket in August 2008.<sup>167</sup> The surveyors searched bank websites, requested information from customer service personnel, and visited bank branches when information was not available.

#### Key Findings:

- All of the largest banks unilaterally pay overdrafts at the bank's discretion and charge per overdraft fees without advance consent from their customers.
- The median top fee for overdrafts is \$35 per incidence, with the top fee ranging from \$34 at CitiBank to \$39 at Citizens Bank. Nine of the sixteen banks charged \$35 for repeat overdrafts. Since August, CitiBank raised its \$30 fee to \$34.
- Half of the surveyed banks tiered overdraft fees, charging escalating fees for more than one overdraft over a rolling thirteen month time period. For example, Regions Bank charges \$25 for the first overdraft in a year, \$33 for the next three overdrafts, and \$35 each for four or more. US Bank charges \$19 the first time, \$35 for the second to fourth overdraft, and \$37.50 thereafter. Fifth Third Bank switched to tiered fees in the last year, previously charging a flat \$33 per overdraft. Fifth Third now charges \$25 for the first overdraft, \$33 for the second to fourth, and \$37 for five or more. In 2005, only three major banks used tiered fees. Bank of America terminated its tiered fees (\$25 for first overdraft in a year), now charging \$35 for each overdraft.
- Nine banks also charge sustained overdraft fees, imposed when overdrafts are not repaid within a few days. These ranged from an extra \$35 charged by Citizens Bank and SunTrust, \$30 charged by BB&T after seven days, \$12.50 added by Chase to Arizona consumers after five days, and per day fees of \$5 to \$8 at other banks. PNC recently raised its sustained overdraft fee from \$6 to \$7 for a maximum of \$35 over five days.
- Only two large banks cap the number of overdraft fees it will levy in one day. CitiBank caps fees at four per day (\$136) while WAMU limits its charges to seven per day (\$238). Bank of America has discontinued its limit of seven overdraft fees per day, permitting unlimited overdrafts effective February 9, 2009.
- Fifteen of the largest banks process withdrawals largest first (or disclose that they pay withdrawals in any order the bank chooses), which results in additional fees when smaller subsequent transactions overdraw an account. This information is generally

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<sup>167</sup> Consumer Federation of America, Comments to the Federal Reserve, August 4, 2008, [http://www.consumerfed.org/pdfs/OD\\_FRB\\_comments.pdf](http://www.consumerfed.org/pdfs/OD_FRB_comments.pdf)

buried in account agreement fine print. CFA did not have sufficient information from one bank to determine processing order.

- The total cost of a single overdraft at the bank's highest fee that is unpaid after seven days ranges from \$74 at Citizens Bank to \$47.50 at Chase in Arizona for the banks that charge a sustained overdraft fee. The combined cost at SunTrust is \$70, with National City imposing \$68 in total fees. Eight months ago, the most expensive seven day overdraft combined fee was \$70 at SunTrust.
- Almost all of the largest banks offer an overdraft line of credit at moderate cost, with fees including a per transfer fee, monthly or annual service charges, or interest only on amount transferred to the line of credit.
- Banks that offer overdraft protection via transfer from savings accounts charge a median fee of \$10 per day funds are transferred. TD Bank does not charge a transfer fee while Fifth Third Bank charges \$20 after twenty-one transfers in a year. PNC doubled its transfer from savings fee in March 2009, from \$5 to \$10. Citizens, HSBC, and National City all charge \$15 per transfer.

See next 5 pages for accompanying chart to Appendix C.

5 Page Chart accompanying Appendix C: CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices

| FIRM            | Fee Schedule On Web | TRADITIONAL OVERDRAFT PROTECTION   |                             |                              |                            |             |                 | Clearance Policy | "COURTESY" OVERDRAFT LOANS                       |  |  |  |   |
|-----------------|---------------------|--|-----------------------------|------------------------------|----------------------------|-------------|-----------------|------------------|--|--|--|--|---|
|                 |                     | Line of Credit transfer fee  | Annual Savings Transfer Fee | Savings Transfer Fee         | Credit Card                | Home Equity | Opt-In Contract |                  | Unpaid NSF/Overdraft Fee                         | Paid Overdraft Fee   | Sustained Overdraft Fee  | After Number of Days                           |   |
| Bank of America | Yes                 | \$10; in increments of \$100   |                             | \$10; in increments of \$100 | see card agreement; varies |             |                 | Yes              | Any; usually high to low                         | \$35 per item; no limit per day                                      | \$35 per item; no limit per day                                      | No   |   |
| BB&T            | no                  | \$10   |                             | \$10                         | \$10                       | yes         |                 |                  | high to low                                      | \$35 per item; no limit per day                                      | \$35 per item; no limit per day                                      | \$30   | 7                                       |
| Chase           | No                  | Yes  | None                        | \$10                         | 13.99% APR                 | Yes         | Yes             |                  | High to low, can change order w/out notice       | \$25-1st time, \$32-2nd,3rd,4th time, \$35 thereafter                | \$25-1st time, \$32-2nd,3rd,4th time, \$35 thereafter                | \$5 to \$25 per day depending on your location | \$12.50 in AZ after 5 consec. Bus. Days |
| Citibank        | Yes                 | Yes; Checking Plus, 16.5% variable APR in most states, \$5 annual membership fee | No                          | \$10                         |                            |             |                 | Yes              | Electronic debits first then usually high to low | \$34; not more than 4 fees per day; fees may also cause an overdraft | \$34; not more than 4 fees per day; fees may also cause an overdraft | No   |   |

**5 Page Chart accompanying Appendix C: CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices**

| FIRM               | Fee Schedule On Web | TRADITIONAL OVERDRAFT PROTECTION                 |                             |   |   |                |                 | Clearance Policy   | "COURTESY" OVERDRAFT LOANS   |  |                         |                       |
|--------------------|---------------------|--|-----------------------------|---|---|----------------|-----------------|--------------------|--|--|-------------------------|-----------------------|
|                    |                     | Line of Credit transfer fee                      | Annual Savings Transfer Fee | Savings Transfer Fee                                      | Credit Card   | Home Equity    | Opt-In Contract |                    | Unpaid NSF/ Overdraft Fee  | Paid Overdraft Fee   | Sustained Overdraft Fee | After Number of Days  |
| Citizens Bank      | No                  | \$15 per day plus \$25 line of credit annual fee |                             | \$15 per day  |   |                |                 |                    | \$25 per item 1st day; \$37 2 OD days, \$39 3 or more OD days      | \$25 per item 1st day; \$37 2 OD days, \$39 3 or more OD days      | \$35                    | Per account agreement |
| Fifth Third Bank   | Yes                 | Yes  | No                          | \$9 for 1-10 uses; \$15 for 11-20 uses; \$20 for 21+ uses | \$9-1-10 times; \$15 11-20 times; \$20 21 or more + APR | Info not found | Yes             | High to low.       | \$25 for 1st time; \$33 for 2nd-4th time; \$37 thereafter per item | \$25 for 1st time; \$33 for 2nd-4th time; \$37 thereafter per item | \$6 per day             | 3 days                |
| HSBC               | no                  | \$15   |                             | \$15  | \$15  |                |                 | high to low        | \$35 per item; no limit per day                                    | \$35 per item; no limit per day                                    | No                      |                       |
| National City Bank | Yes                 | \$3 mo. Service fee; 24.8% APR                   |                             | \$15  |   |                | Yes             | High to low (2005) | \$30-36; based on NSF activity and balances                        | \$30-36; based on NSF activity and balances                        | \$8.00                  | 3 days                |

**5 Page Chart accompanying Appendix C: CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices**

| FIRM     | Fee Schedule On Web | TRADITIONAL OVERDRAFT PROTECTION   |                             |   |  |             |   | Clearance Policy  | "COURTESY" OVERDRAFT LOANS                                       |  |   |  |
|----------|---------------------|--|-----------------------------|---|--|-------------|---|---|--|--|---|--|
|          |                     | Line of Credit transfer fee  | Annual Savings Transfer Fee | Savings Transfer Fee  | Credit Card  | Home Equity | Opt-In Contract   |   | Unpaid NSF/Overdraft Fee   | Paid Overdraft Fee   | Sustained Overdraft Fee                           | After Number of Days   |
| PNC Bank | Yes                 | Yes  | No                          | Yes, \$5 transfer fee, \$50 minimum transfer (\$10 transfer fee effective March 6, 2009)          | Yes, \$5 transfer fee, \$50 minimum transfer (\$10 transfer fee effective March 6, 2009) |             | Yes; w/ set up fee of \$15 for Free Checking, \$5 for Foundation Checking, and free for all other checking accounts | High to low (2008)  | 1-3 items = \$31/item<br>4-6 items = \$34/item<br>7+ = \$36/item | 1-3 items = \$31/item<br>4-6 items = \$34/item<br>7+ = \$36/item | \$6 per day (\$7 per day effective March 6, 2009) | 4 (for up to 5 days = \$30 max total) (\$35 max effective March 6, 2009) |
| Regions  | No                  | Yes, \$10 transfer fee per day, \$7.50 per day for Preferred Plus Banking, revised February 2009 | No                          | Yes, \$10 transfer fee per day, \$7.50 per day for Preferred Plus Banking, revised February, 2009 | Yes, \$10 fee per day, \$7.50 for Preferred Plus Banking.. February 2009                 |             | Yes, subject to credit approval. Transfers in \$100 increments.   | Any order, reserve right to pay largest first, to change order without notice | 1 item = \$25<br>2-3 items = \$33<br>4+ items = \$35             | 1 item = \$25<br>2-3 items = \$33<br>4+ items = \$35             | No  |  |

5 Page Chart accompanying Appendix C: CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices

| FIRM     | Fee Schedule On Web | TRADITIONAL OVERDRAFT PROTECTION                 |                             |   |   |             |                 | Clearance Policy               | "COURTESY" OVERDRAFT LOANS  |   |                         |                      |
|----------|---------------------|--|-----------------------------|---|---|-------------|-----------------|--------------------------------|---|---|-------------------------|----------------------|
|          |                     | Line of Credit transfer fee                      | Annual Savings Transfer Fee | Savings Transfer Fee  | Credit Card   | Home Equity | Opt-In Contract |                                | Unpaid NSF/ Overdraft Fee   | Paid Overdraft Fee  | Sustained Overdraft Fee | After Number of Days |
| SunTrust | Yes                 | Yes  | No                          | \$10 transfer fee (max one per day) \$100 transfer increments   | Yes   |             | Yes             | Any; usually high to low       | \$35  | \$35  | \$35                    | 7                    |
| TD Bank  | No                  |  |                             | no transfer fee   | no transfer fee   |             |                 | any order                      | \$35 per item; no limit per day                                   | \$35 per item; no limit per day                                   | No                      |                      |
| US Bank  | Yes                 | Yes, three different lines of credit are offered |                             | \$5 fee on deposit account per item covered for all overdrafts, auto increments of \$200 or avail balance | Yes, \$10 fee, payments are 3% of balance or \$10, auto increments of \$25 up to credit limit | Yes         | Yes             | Any; bank has total discretion | \$19 1st time, \$35 2nd-4th time, \$37.50 5th time and thereafter | \$19 1st time, \$35 2nd-4th time, \$37.50 5th time and thereafter | \$8                     | 3 days               |

**5 Page Chart accompanying Appendix C: CFA Survey of Sixteen Large Banks' Overdraft Fees and Practices**

| FIRM              | Fee Schedule On Web | TRADITIONAL OVERDRAFT PROTECTION |                             |                                |  |             |                 | Clearance Policy   | "COURTESY" OVERDRAFT LOANS             |   |   |                          |        |
|-------------------|---------------------|----------------------------------|-----------------------------|--------------------------------|--|-------------|-----------------|--|--|---|---|--------------------------|--------|
|                   |                     | Line of Credit transfer fee      | Annual Savings Transfer Fee | Savings Transfer Fee           | Credit Card  | Home Equity | Opt-In Contract |  | Unpaid NSF/Overdraft Fee               | Paid Overdraft Fee  | Sustained Overdraft Fee   | After Number of Days     |        |
| Wachovia          | No                  | Yes, \$10 transfer fee           | No                          | Yes, \$10 transfer fee         | Yes, \$5 transfer fee + APR                                  |             |                 | Yes  | Any; usually high to low               | \$22 1st time and \$35 each additional time                           | \$22 1st time and \$35 each additional time                           | No                       |        |
| Washington Mutual | No                  |                                  |                             | \$12 if balance under \$10,000 |  |             |                 | "Overdraft Limits" program is automatic, other programs are opt-in | Any. Preference given to WAMU payments | \$34 each, max 7 per day or \$238 CA                                  | \$34 each, max 7 per day or \$238 CA                                  | No                       |        |
| Wells Fargo       | some info online    | \$10                             |                             | \$10 per day                   | \$10-\$20 depending on \$ amount of advance; one fee per day |             |                 |  | high to low                            | \$22 - 1st time; \$35 - thereafter; no limit to how many fees per day | \$22 - 1st time; \$35 - thereafter; no limit to how many fees per day | \$5 per business day, CA | 3 days |