Written Testimony of Mike Calhoun
President, Center for Responsible Lending

Before the Senate Banking Committee

on

“Enhanced Consumer Financial Protection After the Financial Crisis”

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538 Dirksen Senate Office Building

Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to testify on the need to maintain strong consumer financial protections in the wake of the financial crisis.

I am President of the Center for Responsible Lending (CRL), a nonprofit, 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, a nonprofit community development financial institution. For thirty years, Self-Help has focused on creating asset-building opportunities for low-income, rural, women-headed, and minority families, primarily through financing safe, affordable home loans. In total, Self-Help has provided over $5.6 billion of financing to 64,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.

In my testimony today, I demonstrate that unsustainable lending pushed us into the financial crisis, and that sustainable lending and responsible consumer financial services products are needed to restore and maintain economic health. An independent Consumer Financial Protection Bureau (CFPB), as enacted by the Dodd-Frank Act (DFA or Dodd-Frank), is critical to reestablishing these sustainable lending practices. Indeed, consumer spending, as 70 percent of gross domestic product, fuels the economy, so promoting a fair, equitable, and transparent consumer marketplace is key to financial stability. Maintaining the independence of the CFPB is necessary to doing so.

I. Federal Banking Regulators Failed to Exercise Oversight Over the Unsustainable Lending Practices that Caused the Financial Crisis

Almost four years ago, CRL released a report warning that reckless and abusive lending practices would lead to approximately two million subprime foreclosures.[1] At the time, our report was denounced by the mortgage industry as absurdly pessimistic. Sadly, the system was even more larded with risk than we reported, and the damage has been far worse, spreading from the subprime to the prime sectors, catalyzing a housing-led recession and triggering historic levels of unemployment.

With all the complexity of today's financial crisis, it's easy to lose sight of the key factor that led to the crisis: unsustainable lending beginning in the 1990s, when abusive subprime lenders put increasing numbers of families into expensive and unnecessarily risky home loans, most often refinancing existing home loans while stripping out much of the equity that those families had built.[2] Federal regulators should have been policing the marketplace and creating fair rules of the game by requiring underwriting to ensure that borrowers could actually afford the loans they received.

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[1] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Costs to Homeowners*, (December 2006), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf.

[2] *See* CRL issue paper, *Subprime Lending: A Net Drain on Homeownership* (March 27, 2007), *available at* http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf.

Instead, federal regulators aided and abetted the lending binge, ignoring the inherently risky practices in the marketplace. Indeed, the financial crisis is largely the result of the breakdown of this nation's regulatory system. The agencies responsible for protecting depositors, shareholders, taxpayers, borrowers, and the general financial system failed. They stood by as predatory practices and dicey lending became commonplace, ravaging the mortgage market and setting off a chain reaction of financial devastation. I offer several examples of this regulatory failure below.

Federal Reserve Board (FRB or Board)

For many years, the FRB failed to effectively use its authority to regulate the mortgage market against unfair or deceptive acts and practices (UDAP) under the Home Ownership and Equity Protection Act (HOEPA) of 1994. In 2000, House Banking Committee Chairman Jim Leach said to the Board:

> Congress six years ago passed a law which was very strong in its sense of purpose in outlawing predatory lending in effect. And then, because Congress felt that the subtleties of this were beyond the Congress, we gave two federal regulators, most specifically the Federal Reserve Board of the United States, the authority to make definitions and to move in this direction. . . . So the question becomes if there is a problem out there: If Congress has given very strong authority to regulators and the Federal Reserve, are regulators and the Federal Reserve AWOL?[3]

At that time, consumer advocates urged the Board to use its HOEPA authority to prohibit abusive practices such as prepayment penalties on mortgages with interest rates greater than conventional rates.[4] While the FRB was failing to act, dozens of states passed their own regulations to address abusive practices.[5]

The Board did eventually act, using its HOEPA authority in July 2008 and participating in 2006 and 2007 in joint agency mortgage lending guidance. Although CRL commended Chairman Bernanke and the Board for promulgating this rule in 2008, it came far too late to stem the tide of foreclosures and the larger financial crisis that ensued; had it been issued just three or four years earlier, countless foreclosures could have been prevented.

Office of the Comptroller of the Currency (OCC)

The OCC also played a key role in the mortgage meltdown, both by actively blocking state consumer protection laws through the expansion of federal preemption and by simultaneously failing to adequately monitor the nationally-chartered lending institutions under its purview.

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[3] Representative Jim Leach, Hearing on Predatory Lending Practices, U.S. House Committee on Banking and Financial Services (May 24, 2000).

[4] Testimony of Martin Eakes, CEO, Center for Community Self-Help, Before the House Committee on Banking and Financial Services, May 24, 2000.

[5] *See* Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms,* Center for Responsible Lending (Feb. 23, 2006), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/rr010-State_Effects-0206.pdf.

From the late 1990s, when anti-predatory lending laws were enacted by several states to provide substantive protections for consumers and place responsible checks on mortgage lending, the OCC worked to expand the reach of its powers and preempt state laws.[6] These state laws were designed both to protect homeowners and to preserve a safe, well-functioning market. Not only did the OCC's stringent preemption policies block strong regulation of federally-chartered entities, but also the immunity of federally-regulated entities prompted arguments from state-chartered entities that strong state reforms would create an uneven playing field on which they could not compete. These arguments served to chill action by state policymakers, and the result was too often a playing field with no rules.

At the same time that the OCC thwarted state efforts, it also ignored evidence of predatory lending within national banks and their affiliates and subsidiaries, simply repeating the mantra that there was no predatory lending in the national banks.[7] Only one OCC enforcement action against national banks from 2000 through 2006 involved subprime mortgage lending.[8] As another example of the OCC's failures, Countrywide booked $161 billion in payment option adjustable rate mortgage loans underwritten only to a very low teaser rate while it was under the watch of the OCC.[9]

The OCC and other banking regulators did not issue the Interagency Guidance on Nontraditional Mortgage Product Risks until late 2006 and the Statement on Subprime Mortgage Lending until June 2007. If the OCC had spent more time performing its duties of oversight rather than attempting to make its charter the most appealing, it could have played an important role in

[6] Former Comptroller John D. Hawke, Jr. described the OCC's use of its power to override state laws protecting consumers as "one of the advantages of a national charter," and asserted that he was "not the least bit ashamed to promote it." The fact that the OCC is funded by assessments from the banks it regulates, rather than by Congressional appropriations (in 2005, 97 percent of the OCC's operations were funded by revenues from assessments), feeds a race to the bottom to attract institutions to its charter. *See* OCC, Annual Report, Fiscal Year 2005 at 7, *available at* www.occ.treas.gov/annrpt/2005AnnualReport.pdf; Jess Bravin & Paul Beckett, "Friendly Watchdog: Federal Regulator Often Helps Banks Fighting Consumers– Dependent on Lenders' Fees, the OCC Takes Banks' Side Against Local, State Laws," at A1 *Wall St. Journal* (Jan. 28, 2002).

[7] *See, e.g.*, OCC News Release 2003-8: OCC Issues Guidelines to National Banks to Guard Against Abusive Lending Practices (Feb. 21, 2003) (comments by Comptroller Hawke that "while the OCC has *no reason to believe that any national bank is engaging in predatory lending*, the agency's guidance will help prevent problems from arising in the future by prescribing steps national banks should take to avoid abusive practices."); Statement Of Comptroller Of The Currency John D. Hawke, Jr. Regarding The Issuance Of Regulations Concerning Preemption And Visitorial Powers (Jan. 7, 2004) ("We have no evidence that national banks (or their subsidiaries) are engaged in such practices to any discernible degree."); OCC, News Release 2004-3: OCC Issues Final Rules on National Bank Preemption and Visitorial Powers; Includes Strong Standard to Keep Predatory Lending out of National Banks (Jan. 7, 2004) ("There is scant evidence that regulated banks are engaged in abusive or predatory practices").

[8] Robert Berner & Brian Grow, "They warned us about the Mortgage Crisis," *Business Week* (October 9, 2008). The OCC's response to consumer complaints has been equally unimpressive. Although the OCC is required to have a separate consumer affairs division, 15 U.S.C. § 57a(f)(1), and largely relies on direct consumer contact with the bank as "the most effective way to resolve a complaint …" *See* OCC, Annual Report Fiscal Year 2004, at 19 (Oct. 2004), *available at* http://www.occ.treas.gov/annrpt/2004AnnualReport.pdf; OCC, 2004 Report of the Ombudsman, at 38 (Dec. 2004), *available at* http://www.occ.treas.gov/2004Report.pdf.

[9] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

averting this crisis. Even today, the OCC continues to push for broad preemption standards even though DFA scaled back the level of federal preemption.[10]

The OCC's thwarting of state efforts continued despite repeated warnings from consumer advocates. For example, as early as 2003, CRL highlighted to the OCC the evidence of predatory lending among national banks and their subsidiaries such as Guaranty National Bank of Tallahassee,[11] Wells Fargo, and First Franklin.[12] And in 2004, Self-Help CEO Martin Eakes testified the following before this very committee: "Abusive practices may well be profitable in the short term, but are ticking time bombs waiting to explode the safety and soundness of national banks in the years ahead. The OCC has not only done a tremendous disservice to hundreds of thousands of borrowers, but has also sown the seeds for future stress on the banking system."[13]

Office of Thrift Supervision (OTS)

The OTS, which today is part of the OCC as a result of Dodd-Frank, offered a stunning record of regulatory ineptitude through the collapse of three institutions under its watch – NetBank, IndyMac and Washington Mutual (WaMu).

An Inspector General's report in the wake of the September 2007 failure of NetBank concluded that the OTS ignored clear warning signs about the bank's risky lending.[14] The Inspector General found that the OTS "did not react in a timely and forceful manner" to "repeated indications of problems in NetBank's operations" – problems that had been evident for years in OTS examinations.[15]

Yet NetBank's failure was simply a prelude to the downfalls of IndyMac and WaMu. Never before in American history have two banks so large failed within months of each other. IndyMac's failure was the fourth largest bank failure in American history, and WaMu's collapse was the largest ever. The OTS failed to take effective action to halt the unsafe and unfair lending practices that eventually doomed both. And even as it became clear that these two banks' loan performances and financial returns were rapidly taking a turn for the worse, the OTS failed to act aggressively to alleviate the damage. In fact, the regulator prevented the Federal Deposit

[10] For a full discussion, *see* Comments of the Center for Responsible Lending, Consumers Union, National Consumer Law Center (on behalf of its low-income clients), Public Citizen, and Sergeant Shriver Center on Poverty Law to the OCC on its preemption proposal (June 27, 2011).
[11] This bank failed and was taken over by the FDIC on March 12, 2004. *See* http://www.fdic.gov/bank/individual/failed/gnb.html.
[12] Center for Responsible Lending, "Comments on OCC Working Paper" at 8-10 (Oct. 6, 2003), *available at* http://www.responsiblelending.org/pdfs/CRLCommentsonOCCWorkingPaper.pdf. The practices included charging exorbitant broker fees, imposing unfair prepayment penalties, evading HOEPA and other consumer protection laws, the high prevalence of 2/28 ARM loans accompanied by 3-year prepayment penalty provisions, as well as racial steering and lending discrimination. *Id.*
[13] Martin Eakes, testimony before the Senate Banking Committee (April 7, 2004). Quoted Senate Banking Committee Report on S. 3217 (which eventually became Dodd-Frank), see http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.
[14] Office of Inspector General, Department of the Treasury, "Material Loss Review of NetBank, FSB," April 23, 2008; OIG-08-032, p. 1.
[15] *Id.* at 3.

Insurance Corporation (FDIC) from taking timely action by declining to put the two banks on the government's list of troubled banks until just before they went under – far too late to make any difference. WaMu and IndyMac were not guileless victims of financial hurricanes they had no control over; the OTS had readily available information about their unsafe and unfair lending practices, but declined to intervene.

The Role of the States

The federal regulators' failures are especially clear in light of the states' efforts. When the federal government failed to act, a number of states moved forward to pass laws to address abusive practices. Research assessing these laws has shown them to have been successful in cutting excessive costs for consumers without hindering access to credit.[16] And other states benefited as well. Spearheaded by active states such as North Carolina, Iowa, Massachusetts, and Illinois, among others, the state Attorneys General pursued enforcement actions and settlements against some of the larger institutions that employed widespread abusive practices. These settlements held bad actors accountable for their actions, brought relief to borrowers and influenced the marketplace nationwide. The success of the states despite the OCC's preemption doctrine especially underscores the failure of federal regulators to act.

II. The Creation of CFPB and Attempts to Weaken It

It was in the context of these massive federal regulatory failures that Congress enacted the Dodd-Frank Act, which included the creation of an independent CFPB. The history of the financial crisis is one in which prudential regulators – tasked with evaluating both safety and soundness and consumer protection concerns – largely focused on short-term profitability, giving short shrift to consumer protection. Even the best-meaning financial regulator will always prioritize its primary function (protecting the safety and soundness of the banks it regulates) over a subsidiary requirement (protecting consumers), particularly where it perceives the two goals to be in conflict. Unfortunately, the lesson was not learned that protecting consumers and bolstering the safety-and-soundness of financial institutions go hand-in-hand in the long term; for example, failing to underwrite loans beyond their teaser rates may lead to greater revenues in the short-term, but the longer-term failure of those loans has a severe adverse impact on individual financial institutions and the economy.

By enacting the CFPB, Congress wisely consolidated the consumer protection functions of the federal prudential regulators into one independent agency with a mission to protect borrowers from abusive financial practices. This will not only benefit borrowers; it also will help ensure the long-term sustainability of financial institutions (which, as we have seen, may fail when their revenues come from unsustainable and abusive consumer lending practices). The CFPB will also help strengthen the overall economy and help prevent another financial crisis.

CFPB's Authority and Structure

[16] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, Housing Policy Debate, (15)(3): (2004); Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms* (2006) *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

Congress gave the CFPB broad rule-writing authority and some supervision and enforcement authority. CFPB rules generally are applicable to all entities. However, the CFPB has supervision authority only over certain institutions: depositories with more than $10B in assets, payday lenders, mortgage-related companies (e.g., mortgage brokers and servicers), private student lenders, and large non-bank entities (to be defined by rule in the future). Prior to enactment of DFA, these non-bank entities were wholly unsupervised by the federal government, and some had little oversight from the states. By bringing many of these previously unregulated entities into the CFPB's purview, DFA helps to even the playing field between bank- and non-bank financial institutions.

To preserve the CFPB's effectiveness, Congress put in place an independent CFPB funding source to match that of the other financial regulators. The Bureau's funding comes primarily as a transfer from the Federal Reserve Board, subject to a statutory cap, although the Director may request additional funding to be appropriated from Congress. This was intended to keep the CFPB on par with other federal banking regulators, which receive their funding without being subject to the Congressional appropriations process, reducing the potential that special interests will attempt to handcuff the agency through the appropriations process.

In addition, Congress put in place a single director who is clearly accountable for the actions (or lack thereof) of the Bureau. Directors who overstep their authority or who do not go far enough to protect consumers cannot deflect blame for their actions. A single director is also parallel to the regulatory structure of the OCC.

Limits to the CFPB's Authority in Dodd-Frank

Although the CFPB does have broad authority to write rules, supervise certain financial institutions, and enforce federal fair lending and consumer protection laws against certain entities, Congress added many checks to the Bureau's power. For example, like all agencies, it must comply with the Administrative Procedures Act. In addition, like only two other agencies and no federal banking regulator, the CFPB must convene small business panels under the Regulatory Flexibility Act before issuing a proposed rule, a process that is expected to add at least six months to the rulemaking process. The CFPB must also specifically consider the benefits and costs of proposed rules to both consumers and businesses, and its actions are subject to judicial review. In addition, the Financial Stability Oversight Council (FSOC) may veto any CFPB rule by a two-thirds vote if it concludes that the rule would pose a risk to the safety and soundness of the banking system or put the stability of the financial system at risk. The CFPB must also publicly review its rules every five years to ensure that they are not overly burdensome and to address key problems, and the CFPB's funding is statutorily capped, unlike any other federal banking regulator.

DFA also put in place additional checks on the CFPB. For example, the CFPB must submit to Congress annual financial reports and is required to report to Congress twice yearly to both justify its budget and provide details on its activities. In addition, the Government Accountability Office must audit the CFPB's expenditures each year and submit a report to Congress, and the CFPB is required to submit its financial plans, forecasts, and quarterly financial reports to the Office of Management and Budget. In addition, the Inspector General of the Federal Reserve Board must inform Congress about the CFPB's work.

Current Proposals to Restructure the CFPB

Despite these checks on the CFPB's powers, several bills and amendments have been introduced in this Congress to modify the CFPB before it even becomes operational. These include:

- S. 737 and the House financial services appropriations bill would permanently tie all of the CFPB's funding to the appropriations process. This would put the Bureau's effectiveness at risk by allowing large banks and other financial players to exert undue influence on the rulemaking process. This proposal is in stark contrast to the funding source of other banking regulators, which remain free of the appropriations process to protect the integrity of the supervision process.
- S. 737 and H.R. 1121 would change the governing structure of the Bureau from a unitary directorship to a five-member Commission. This would result in less accountability, as commissioners could avoid responsibility by pointing to the other four people who make up the Commission. H.R. 1121 would reserve one of the five commission slots for the FRB, which as outlined above failed to act to protect borrowers against predatory lending practices until it was far too late to avoid a crisis. S. Amdt. 391 to S. 782 would go even further. It would establish a six-person Board, with three of the Board members reserved for prudential regulators (the OCC, FDIC, and FRB). An even number of Board members on its own would make it hard to establish a clear majority to enact consumer protection rules; reserving three spots for prudential regulators would make it nearly impossible to do so. It was, after all, the prudential regulators who failed to act when they had the authority to do so leading up to the financial crisis. Again, this is in stark contrast to the OCC, which can move forward with regulations and enforcement actions under the leadership of a single director.
- H.R. 1315 would expand FSOC's veto authority in harmful ways. It would lower the threshold vote required for the veto from a two thirds vote to a simple majority, and it would change the threshold for the veto from one of systemic risk to the financial system as a whole to the safety and soundness of financial institutions. This would undermine the purpose of the CFPB and fly in the face of the causes of the financial crisis outlined above. Prudential regulators, by putting short-term safety and soundness over consumer protection, actually created long-term systemic risk to the entire financial system. Giving prudential regulators greater ability to overturn CFPB rules makes no sense given this history.

  In addition, sometimes practices that are abusive to banks' customers are beneficial to the safety and soundness of institutions that engage in it. For example, today many financial institutions routinely reorder debit card transactions from highest to lowest to maximize the overdraft fees they can charge. Certainly, this contributes to the revenues of those institutions in the near-term, but in the longer term, it harms the financial stability of banks' customers who could otherwise put that money to productive use in the economy. It also drives some out of the banking system altogether, and it runs counter to principles of fairness and transparency necessary to a competitive, healthy marketplace.

> Similarly, during the subprime crisis, mortgage brokers benefited greatly from "yield spread premiums," which provided them with greater compensation from lenders if they placed borrowers in loans with higher interest rates than the borrowers qualified for, and the banks who gave those rewards benefitted from the higher-priced loans that resulted. Dodd-Frank expressly eliminated the practice; CFPB's rules to implement the law would run afoul of the proposed congressional standard because some mortgage brokers would be harmed by no longer being able to mislead customers. And, for a time, regulators and banks insisted that the practices could not be risky because they were profitable. By equating short-term profitability with safety and soundness, the industry and its regulators failed to understand that in the long run, abusive practices erode the stability of the people the banks ultimately depend on – their customers.

Individually and together, these proposals would cripple the effectiveness of the CFP and hamper its role to create a faster economic recovery and, just as important, to prevent another financial crisis from emerging in the future.

III. <u>An Effective CFPB Remains Critical Today</u>

Unfortunately for consumers, financial abuses continue today, making the CFPB's success as important as ever. Below we provide an overview of several abusive practices that greatly harm consumers. In each of these cases, federal banking regulators have done little to protect consumers from these abusive products. The CFPB, with its consumer protection mission, is in the best place to establish basic rules of the road to enhance both consumer protection and a robust competitive market.

Mortgage Servicing

Widespread mortgage delinquencies have laid bare many of the abuses and failures that have existed within the mortgage servicing industry even before the current crisis. For at least a decade, community-based organizations, housing counselors, and advocates around the country have documented a pattern of shoddy, abusive, and illegal practices by many mortgage servicers. Mortgage servicers have staff who are trained for collection activities rather than loss mitigation, infrastructure that cannot handle the present level of demand, and business records that are an utter mess.[17] Unfortunately, the prudential regulators chose not to use their authority to regulate this industry in the past; as a result, there is now a greater need than ever for the CFPB to serve as a cop on the beat.

Overview of Servicing Abuses

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[17] *See, e.g., In re Ocwen Loan Servicing, LLC Mortg. Servicing Litigation,* 491 F.3d 638 (7th Cir. 2007) (allegations by a class of homeowners that Ocwen systematically charged late fees for payments that were sent on time); *Federal Trade Commission (FTC) Settlement* (2003) resulted in $40 million for consumers harmed by illegal loan servicing practices, *available at* http://www.ftc.gov/fairbanks (FTC alleged, among other things, that Fairbanks illegally charged homeowners for "forced placed insurance" and violated the Fair Debt Collection Practices Act); and *FTC Settlement with Countrywide, available at* http://www.ftc.gov/countrywide (Countrywide agreed to pay $108 million dollars to homeowners in response to the FTC's allegations that Countrywide charged illegal fees to homeowners during Chapter 13 bankruptcy proceedings).

Abusive practices have become so ingrained in the servicing culture that they are now endemic to the industry. The harm to which borrowers have been subjected as a result of these abuses cannot be overstated. Numerous homeowners are burdened with unsupported and inflated mortgage balances or have been subjected to unnecessary and/or wrongful foreclosures before loss mitigation measures have been fully considered. These abuses include the following:

- *Dual track*. Servicers actively pursue foreclosure even when they are already working with homeowners on a modification, often leading to unnecessary foreclosures before a decision on the loan modification has been made.
- *Foreclosing even when investors would receive more from a sustainable modification*. It is in the best interests of investors and borrowers, and a requirement under the Home Affordable Modification Program (HAMP), that servicers modify a mortgage loan when its net present value (NPV) positive, *i.e.*, when the expected return to investors from a modified loan is greater than the expected return from a foreclosure. Unfortunately, this is not happening systematically.
- *Improper denial and delay of loan modification requests*. Delay can be in servicers' interests because fees, which eventually flow directly to servicers (either from the homeowner directly or through the proceeds of a foreclosure sale down the road), continue to accrue. A ProPublica study highlights the problems this creates for distressed borrowers: The homeowners interviewed spent an average of more than 14 months waiting for a HAMP modification (a process that should only take a few months), and "as a result of the delays, homeowners fall further behind, putting them in danger of foreclosure and making it less likely they'll qualify for a modification. About two-thirds of these homeowners were still current on their mortgages when they began the process, but most have now fallen behind."[18]
- *Forcing homeowners into multiple temporary modifications.* All modifications are not created equal. Extended temporary modifications are good for servicers' interests but harm those of borrowers. Temporary modifications can represent a best-of-both-worlds situation for servicers, who continue to charge fees as if the borrower is in default but without the cost of having to finance principal and interest advances to investors. Many borrowers go from one temporary modification to another, continuing to accrue high fees that drive them even further underwater.
- *Force-placed insurance.* Servicers too often force-place very expensive hazard or other insurance and charge the borrower's account when the borrower's insurance has not lapsed (or is not needed as may be the case with flood insurance), often driving an otherwise current borrower into delinquency and even foreclosure.
- *Improper fees.* Servicers sometimes charge unlawful default- and delinquency-related fees for property monitoring and broker price opinions.
- *Requiring borrowers to give up legal rights in order to receive a modification*. This is even more egregious considering that some temporary modifications are not in borrowers' interests, making legal rights the only effective bargaining chip for such borrowers to enter into permanent and affordable modifications.

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[18] *See, e.g.,* Paul Kiel & Olga Pierce, "Homeowner Questionnaire Shows Banks Violating Gov't Program Rules," *ProPublica* (Aug. 16, 2010), available at http://www.propublica.org/article/homeowner-questionnaire-shows-banks-violating-govt-program-rules.

- *Misapplication of borrower payments.* This results in inappropriate and unauthorized late fees and other charges, as well as misuse of borrower funds improperly placed in "suspense" accounts, which creates income for servicers.
- *Mismanaged escrow accounts.* Servicers sometimes improperly manage borrower accounts for real estate tax and insurance escrows, including by failing to disburse payments for insurance and taxes on time, causing cancellation and then improper force-placing of insurance, as well as tax delinquencies and tax sales.
- *Failing or refusing to provide payoff quotations to borrowers*. This may prevent borrowers from obtaining a refinance loan or a short sale.
- *Abuses in the default and delinquency process*. Servicers sometimes fail to properly send notices of default; prematurely initiate foreclosures during right-to-cure periods and immediately following transfer from another servicer, and without proper notices to borrowers; initiate foreclosure when a borrower is not in default or when borrower has cured the default by paying the required amount; and fail to adhere to loss mitigation requirements of investors.

The Need for CFPB Action

In today's housing market, when millions of families are in default and at risk of losing their homes, servicers should work to minimize the number of foreclosures by offering modifications whenever possible and economical. This requires servicers to distinguish between necessary (NPV negative) and unnecessary (NPV positive) foreclosure cases so that they can proceed swiftly with the necessary foreclosures and offer sustainable, long-term modifications when foreclosure is unnecessary.

Instead, the servicing system is compounding the problem by proceeding with many unnecessary foreclosures, which harms not only investors and homeowners, but also neighborhoods and communities as well as the larger economy through spillover effects and other negative externalities. Perverse financial incentives in pooling and servicing contracts illustrate why servicers press forward with foreclosures when other solutions are more advantageous for investors. Servicers are generally paid a fixed percentage of the outstanding balance on a loan for servicing a mortgage when payments are being made on the loan. The traditional mortgage servicing paradigm was marked by a collections mentality, and compensation reflected that mentality. The foreclosure crisis, however, created a need for massive underwriting of loan modifications, and as a result, fees paid for servicing a non-delinquent loan are much too low.[19] According to Amherst Securities, with a typical servicing fee of 25 basis points per year ($625/year on a $250,000 loan), servicers are overpaid for traditional servicing (which costs servicers only about $48/year) and underpaid for loss mitigation on non-performing loans (which costs about $900/year).[20] On the flip side, servicers may charge and collect a variety of fees after

[19] Testimony of Laurie Goodman of Amherst Securities Group to the Subcommittee on Housing Transportation, and Community Development of the Senate Committee on Banking, Housing, and Urban Affairs, National Mortgage Servicing Standards and Conflicts of Interest (May 11, 2011), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=484c5b2b-6924-459f-898e-3ae075feeb15.

[20] *See* Laurie Goodman, et al, "Alternative Compensation Arrangements for Mortgage Servicing – The Debate Begins," *Amherst Mortgage Insight* (Feb. 2, 2011): "[T]here is widespread awareness that the current system (in

the homeowner goes into default and can recover the full amount of those fees from the foreclosure proceeds, providing strong incentives for proceeding with foreclosure.[21] Unfortunately, borrowers cannot protect themselves by shopping for a better servicer, because they are tied to whoever services their loan for as long as the loan is outstanding.

The conflicts of interest between investors and servicers continue, and ultimately borrowers, communities, and the overall economy all suffer. A robust and independent CFPB is needed to create basic ground rules in servicing that apply to all and that are enforced as to all.

Debt Settlement Industry

Debt settlement is another industry that demonstrates the need for the CFPB. Debt settlement companies advertise that they can eliminate consumer debt by negotiating reduced debt payoffs with a consumer's creditors for unsecured debt such as credit card debt and medical bills, with the consumer often paying up-front for services.[22] In reality, little debt is actually settled.

As discussed in more detail below, the limited existing data show that, at best, debt settlement is beneficial for only a small percentage of consumers struggling with debt; many debt settlement participants are left worse off than if they had never enrolled in the program. This harms the economy in that it drains consumers' resources that could otherwise be channeled back into the economy in a more productive way. Moreover, debt settlement companies require that consumers stop paying their debts – usually credit card debts – thereby having a negative impact on the bottom lines of the banks that usually end up having to write off the debt.

Available Data Show Poor Results for Debt Settlement Programs

Robust data on the debt settlement industry are not available; our hope is that more data will become available once the CFPB gets up and running. The few data that are currently available demonstrate the need for greater oversight of the industry.

The data most favorable to the industry come from The Association of Settlement Companies (TASC), one of two debt settlement industry trade associations, in a comment letter to the

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which a minimum servicing fee is part of the mortgage rate) was not designed for current market conditions. This minimum servicing fee is far too high for performing loans and far too low for non-performing loans.

[21] For a thorough discussion of the servicing incentive structure, see Testimony of Diane Thompson before the Senate Banking Committee (Nov. 16, 2010), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=df8cb685-c1bf-4eea-941d-cf9d5173873a&Witness_ID=d9df823a-05d7-400f-b45a-104a412e2202; *see also* Diane Thompson, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior," (National Consumer Law Center Oct. 2009), available at http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/servicer-report1009.pdf.

[22] *See, e.g.*, http://debtmerica.com/ ("Resolve Debt in as little as 24–48 months"); http://www.freedomdebtrelief.com/debtreduction.php ("FDR's Fresh Start Program, also known as Debt Negotiation or Debt Settlement, is an aggressive approach to becoming free of unsecured debts."); www.dmbfinance.com ("DMB Financial's typical client has seen over 50 percent of their unsecured debt negotiated away and is debt free in as little as 36 months.").

Federal Trade Commission.[23] The data show that nearly two-thirds of consumers who enrolled in a debt settlement program terminated before completing the program, while less than one-quarter actually "completed" the program.[24] The TASC survey found:

- 65.6 percent of those enrolled terminated before completion.
- 42.8 percent of those enrolled had no debt settled at all.
- Only 24.6 percent of consumers successfully "completed" the program (with at least 70 percent of debt settled).

Additional data come from the Colorado Attorney General whose second annual report, released in September 2010 (with data from 2006-2009), showed a similarly low success rate for debt settlement companies:[25]

- More than 60 percent of consumers who had signed up in 2006, 2007 or 2008 had already terminated as of Dec. 31, 2009. More than 40 percent of those who had enrolled in 2009 had also terminated.[26]
- By the end of 2009, only 11.35 percent of consumers who had enrolled more than three years earlier and 9.53 percent of those who enrolled in 2007 had completed the program.
- The average program term was 39.18 months.
- Through the end of 2009, enrollees paid an average of nearly $1,000 in fees, regardless of whether any debt was ever settled.

The limited data that exist indicate that, at best, debt settlement is beneficial for only a small percentage of consumers struggling with debt; many debt settlement participants actually end up financially worse off than when they entered the program. Tellingly, the industry has admitted that to require a debt settlement company to meet a standard that a "majority (at least 50 percent) of its clients successfully complete its program and obtain a reduction in debt that is significant

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[23] Letter from the Association of Settlement Companies (TASC) to the Federal Trade Commission, commenting on the FTC's proposed amendments to the Telemarketing Sales Rule on the marketing of debt relief services at 9-11 (Oct. 26, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00202.pdf. TASC was an industry trade group for the debt settlement industry. It has recently rebranded itself as the American Fair Credit Council. *See* http://www.americanfaircreditcouncil.org/.

[24] Completion is defined as at least 70 percent of debt settled. It is interesting that the industry counts success as settling 70 percent of debt, but represents that it will eliminate consumers' debt, and charges its fees based on 100 percent of the debt.

[25] *See* "Press Release: Attorney General Unveils First Annual Report On Debt Settlement, Credit Counseling Business Practices," available at http://www.coloradoattorneygeneral.gov/press/news/2009/10/15/attorney_general_unveils_first_annual_report_debt_settlement_credit_counseling; 2009 Annual Report – *Colorado Debt Management Service Providers*, available at http://www.coloradoattorneygeneral.gov/sites/default/files/press_releases/2010/09/24/2009_dm_annual_report.pdf. *2008 Annual Report – Colorado Debt Management Service Providers*, available at http://coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/2008%20DM%20Annual%20Report.pdf. Moreover, 28.38 percent of those who enrolled in 2008 cancelled before the year was done. *See 2008 Annual Report*.

[26] *See* "Press Release: Attorney General Unveils First Annual Report On Debt Settlement, Credit Counseling Business Practices," available at http://www.coloradoattorneygeneral.gov/press/news/2009/10/15/attorney_general_unveils_first_annual_report_debt_settlement_credit_counseling; *2008 Annual Report – Colorado Debt Management Service Providers*, available at http://coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/2008%20DM%20Annual%20Report.pdf.

and exceeds the fees charged by the company, … *requires an unrealistic measure of programs' success rate*"[27] [emphasis added].

Adverse Impacts of Debt Settlement Programs

The American Bankers Association explained in a comment letter to the FTC that "many [debt settlement] consumers find themselves deeper in debt, with a seriously impaired credit record, and facing continued collection efforts – including collection lawsuits and garnishment proceedings – following their engagement of a for-profit debt relief provider."[28] In addition, stopping payments to creditors as part of a debt settlement plan can reduce a consumer's credit score anywhere between 65 and 125 points.[29] Missed payments can remain on a consumer's credit report for seven years, even after a debt is settled.[30] Even worse, many consumers who enroll in debt settlement programs end up having to file for bankruptcy.

FTC Action on Debt Relief

On 29 July 2010, the FTC issued amendments to the Telemarketing Sales Rule (TSR) relating to debt relief services, including a ban on advance fees and some other limited conduct restrictions for covered providers and transactions. However, there are notable gaps in the rule because of the FTC's limited jurisdiction and the scope of the TSR. For example, the rule excludes nonprofits, intrastate calls, certain transactions with face-to-face contact, and internet-only transactions. In addition, the rule does not require any data collection or reporting.

Following the FTC rule, many debt collection industry players have moved away from the advance fee model that dominated the industry before the rule was in place. The FTC rule thus did improve the industry. However, whether these players will be more successful in settling debts for consumers and in providing a net benefit to these consumers remains to be seen. The fee structures charged by the majority of these companies continue to be not well aligned with the interests of the consumers; fees are calculated based upon the amount of debt enrolled in the program and not based upon the amount of money saved for consumers through a settlement. Given the other harms engendered by debt settlement programs, consumers can still often find themselves paying fees early in the program but still ending up worse off.

Some debt settlement providers have sought to evade the FTC's advance fee ban, largely by contracting with attorneys or others to hold pro forma face-to-face meetings with potential customers but who do not actually do the work. In such cases, the debt settlement company

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[27] U.S. Government Accountability Office Rep. No. GAO-10-593T, *Debt Settlement: Fraudulent, Abusive, and Deceptive Practices Pose Risk to Consumers* at 13 (Apr. 22, 2010) [hereinafter "*GAO Report*"], available at http://www.gao.gov/new.items/d10593t.pdf.
[28] Comments of the American Bankers Association to Federal Trade Commission re Telemarketing Sales Rule – Debt Relief Amendments, Matter No. R4110011 at 2 (Oct. 26, 2009), available at http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00199.pdf.
[29] *GAO Report* at 10, 14.
[30] *Id.*

charges up front and ongoing advance fees whether or not any debt is ever settled for consumers.[31]

Need for CFPB Action

Notwithstanding the FTC's limited but helpful action on debt relief, stronger monitoring and oversight of the overall industry and more complete data collection relating to the impact of current practices are needed to ensure that debt relief activities are productive enterprises that increase, rather than decrease, the ability of consumers to bounce back from insurmountable debt and become productive consumers who contribute positively to the economy again.

Oversight and supervision of the debt settlement industry would also bring long-term benefits to the economy. When consumers are struggling financially, they cut their spending significantly. High or inappropriate program fees for debt settlement keep consumers from settling debt quickly. They also prevent consumers from returning to responsible spending habits that would help keep and create jobs in their local communities and add to the local tax base through sales and income taxes. Ensuring that debt settlement companies across the board – including non-profit entities, lawyers, and any other actors – are engaging in conduct that provides a net benefit for the majority of consumers services, will bring about a quicker financial turnaround for consumers, and consequently, a quicker economic recovery.

Payday Lending

Payday lending harms borrowers and is a net drain on the economy, diverting consumers' resources that could otherwise be channeled into the economy in a more productive way. Independent academic research cited below demonstrates that payday lending increases a borrower's chances of filing for bankruptcy, becoming delinquent on a credit card, having a hard time paying other bills, delaying medical care and prescription drug purchases, and losing their bank account (becoming unbanked). All of these have negative overall impacts on the economy and warrant intervention by the CFPB to ensure an equitable, fair and transparent consumer marketplace for credit that works for consumers and uplifts the economy.

Payday Loan Product and Industry

Payday loans are short-term cash loans based on personal checks held for future deposit or on electronic access to the borrower's bank account, depending on the terms of state laws. Borrowers write a personal check or provide electronic access to their bank accounts for the amount borrowed plus the finance charge and receive cash. Lenders hold checks until the next payday when loans and the finance charge must be paid in one lump sum, with a single paycheck. To pay a loan, borrowers can redeem the check for cash, allow the check to be deposited, or pay the finance charge to roll the loan over for another pay period.

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[31] *See, e.g.*, Press Release, "Attorney General Madigan: Pocketbook Issues Continue to Top Consumer Concerns in 2010; Madigan Files Lawsuit Aimed at New Wave of Consumer Debt Settlement Scams" (Mar. 2, 2011), available at http://illinoisattorneygeneral.gov/pressroom/2011_03/20110302.html.

Payday loans typically range from $100 to $1,000, depending on state legal maximums. The typical loan term is about two weeks. The finance charge for a payday loan ranges from around $15 per $100 borrowed to $30 per $100, resulting in annual interest rates from 391 percent to 782 percent for a two-week extension of credit.[32]

In order to obtain a payday loan, a borrower merely has to have an open bank account, a source of income from a job or public benefits such as Social Security, and a valid form of identification. Lenders do not determine if a borrower can afford to repay the loan from the borrower's income rather than from taking out a new loan. Although failing to repay is typically reported to mainstream credit reporting services, successful repayment of a payday loan is not reported, and therefore, does not improve a consumer's credit score.

Overview of Problems in Payday Lending Industry

Payday loans are advertised as a way to receive a loan for an occasional financial emergency, yet in reality, most borrowers find themselves in long-term, high-cost debt traps because the predatory structure of the payday lending business model sets these borrowers up for failure.[33] The fundamental problems with the payday loan product that lead to long-term payday debt include: (1) the high annual percentage rate on these loans, (2) the short time period in which a borrower has to repay the debt in one balloon payment, (3) the holding of a check or access to the borrower's bank account as collateral, and (4) a lack of consideration of the borrower's true ability to repay the loan in the required timeframe.

The vast majority of payday lenders' business comes from borrowers who take out significant numbers of loans because of the high cost and short repayment period; payday loans are not designed to be taken out just once. Consider the following:

- The average payday borrower takes out nine loans a year, generally on a consecutive basis with more than one transaction per month.[34]
- CRL's national report, *Phantom Demand*, found that a full three quarters of payday loan volume is generated by borrowers who, after paying back the first loan, must re-borrow before their next pay period.[35] In other words, most of the "demand" for payday loans is created by payday loans themselves, and not by consumers' independent financial need.[36]

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[32] Payday loans are subject to Truth in Lending requirements, per court decisions and a Federal Reserve Board ruling in 2000. *See* Federal Reserve Board, Official Staff Commentary § 226.2(a)(14)-2, issued March 24, 2000.

[33] FDIC's Office of the Inspector General (OIG), Challenges and FDIC Efforts Related to Predatory Lending, Audit Report No. 06-011, June 2006 ("Characteristics potentially associated with predatory lending include, but are not limited to, (1) abusive collection practices, (2) balloon payments with unrealistic repayment terms, (3) equity stripping associated with repeated refinancing and excessive fees, and (4) excessive interest rates that may involve steering a borrower to a higher-cost loan.") Payday lending is listed as an example. "Payday Loans are small-dollar, unsecured, short-term advances that have high fees relative to the size of the loan. When used frequently or for long periods, the total costs can rapidly exceed the amount borrowed." *Id.*

[34] Uriah King, Leslie Parrish & Ozlem Tanik, *Financial Quicksand: Payday lending sinks borrowers in debt with $4.2 billion in predatory fees each year*, Center for Responsible Lending (Nov. 30, 2006) *available at* http://www.cha.wa.gov/?q=files/paydayloanstudy.pdf.

[35] Leslie Parrish & Uriah King, *Phantom Demand: Short-Tern Due Date Generates Need for Repeat Payday Loans, Accounting for 76 percent of Total Volume* (July 9, 2009), available at http://www.responsiblelending.org/payday-

- Nationally, over 90 percent of all loans go to borrowers with five or more loans annually; 60 percent of all loans go to borrowers with 12 or more transactions per year; and 24 percent of loans go to borrowers with 21or more loans per year.[37]
- CRL's recent report, *Payday Loans, Inc.: Short on Credit, Long on Debt* found that in their first year of borrowing, the average payday borrower remained in debt for 212 days of the year.[38] The report also found that payday borrowers tend to become more frequent users of payday loans as time passes: the group averaged nine loans in the first year and 12 in the second year; eventually, nearly half (44 percent), defaulted.[39]

Adverse Impacts for Payday Borrowers

The predatory elements of payday loans cause borrowers to take out one loan after another, without reducing principal. In most cases, payday borrowers end up far worse off than if they had never taken out their first payday loans. For example:

- *Payday loan borrowers are worse off than consumers who have no access to payday loans*. Colby College researchers simulated families trying to pay bills despite budgetary constraints over a 30-month period. Borrowers who used the typical volume of payday loans per customer per year for this industry were found to be worse off financially than those without access to payday loans.[40]
- *Using payday loans causes financial hardship for families*. A University of Chicago Business School doctoral student compared households in states with and without access to payday loans over a five year period and found that access to payday loans increases the chances that a family will face hardship, have difficulty paying bills, and have to delay medical care, dental care, and prescription drug purchases.[41] These finding are bolstered by findings in the Detroit Area Study (DAS), conducted by a University of Michigan law professor. Comparing payday loan users with similar low- to moderate-income households in Detroit who did not use payday loans, the DAS found almost three times the rate of bankruptcy, double the rate of evictions and phone cutoff, and almost three times the rate of having utilities shut off.[42]

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lending/research-analysis/phantom-demand-short-term-due-date-generates-need-for-repeat-payday-loans-accounting-for-76-of-total-volume.html.

[36] *Id.*

[37] Uriah King & Leslie Parrish, *Springing the Debt Trap: Rate Caps are Only Proven Payday Lending Reform* (Dec. 13, 2007), available at http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.html.

[38] Uriah King & Leslie Parrish, *Payday Loans, Inc.: Short on Credit, Long on Debt* at 5 (Mar. 31, 2011), available at http://www.responsiblelending.org/payday-lending/research-analysis/payday-loan-inc.pdf. The report was based upon 11,000 Oklahoma payday borrowers who were tracked for 24 months after their first payday loan.

[39] *Id.* at 6-7.

[40] Bart J. Wilson, David W. Findlay, James W. Meehan, Jr., Charissa P. Wellford & Karl Schurter, *An Experimental Analysis of the Demand for Payday Loans* (Apr. 1, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1083796.

[41] Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market* (Nov. 15, 2007), available at http://home.uchicago.edu/%7Ebmelzer/RealCosts_Melzer.pdf.

[42] Michael S. Barr, *Financial Services, Savings, & Borrowing Among LMI Households in the Mainstream Banking*

- *Using payday loans increases the chance of losing a bank account*. Harvard Business School researchers examined involuntary bank account closures in states where payday loans are available and states where these loans are prohibited to determine the impact of loan availability on account closure. The study found that an increase in the number of payday loan outlets in a county is associated with an 11 percent increase in involuntary bank account closures, even when other variables such as income and poverty rate are taken into account.[43] Researchers focused on Georgia, a state that bans payday loans but is surrounded by states that permit the product.[44] Counties at least 60 miles from the border with payday loan states had a 15.6 percent decline in account closures when Georgia expelled payday lending.[45]
- *Payday loan users who also have credit cards are twice as likely to become delinquent on the card*. Researchers at the Chicago Federal Reserve Bank, Vanderbilt University, and the University of Pennsylvania examined a large sample of payday loan users who also had a credit card from a major issuer.[46] They found that taking out a payday loan makes a borrower almost twice as likely as other credit card customers to become seriously delinquent on their credit car during the next year (11 percent for payday borrowers vs. six percent for all credit card users overall).[47]
- *Using payday loans causes borrowers to file for bankruptcy*. In a large Texas study, researchers found that payday borrowers were about twice as likely to file for bankruptcy in the two years following payday use compared with similarly-situated payday loan applicants who were turned down for payday loans.[48]

Need for CFPB Action

The CFPB will play a critical rule in ensuring a fair, equitable, and transparent consumer marketplace for credit in general, including payday loans. CFPB action on payday loans would also even the playing field between banks whose lending activities are regulated at the federal level (even, as discussed below, for payday loans offered by banks) and payday lenders whose activities are not federally regulated.

As previously discussed, if the financial crisis taught us anything, it should be that reasonable underwriting of loans, and particularly a determination that the borrower can afford to repay a loan without relying on another loan or an appreciating real estate market to come up with the money to pay it off, is crucial to long term stability. In the case of mortgage loans, federal banking regulators did not act to effectively address predatory and unaffordable mortgages when the housing market continued to rise, as borrowers could refinance into new mortgages whenever

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& Alternative Financial Services Sectors (Federal Trade Commission Oct. 30, 2008). Presentation of findings available at http://www.clevelandfed.org/research/Conferences/2009/2-6-2009/Keys_presentation.pdf.

[43] Dennis Campbell, Asis Martinez Jerez & Peter Tufano, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures* (June 6, 2008), available at www.box.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf.

[44] *Id.*

[45] *Id.*

[46] Sumit Agarwal, Paige M. Skiba & Jeremy B. Tobacman, *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?* (Jan. 13, 2009), available at http://ssrn.com/abstract=1327125.

[47] *Id.*

[48] Paige M. Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (Oct. 10, 2008), available at http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221.

a problem arose (and numerous mortgage lenders like Countrywide, Ameriquest, IndyMac and others took advantage of this and profited handsomely). Once the housing market cooled and borrowers could no longer refinance out of unaffordable loans, however, the whole system crashed – bringing down lenders, borrowers and the economy. The same problem occurs with payday lending, as borrowers essentially refinance unaffordable payday loans by getting new ones. When the borrowers come crashing down, however, their inability to pay other debts and purchase products, their potential loss of a bank account or fall into bankruptcy are consequences that affect the economy, not just the individual. For these reasons, supervision, oversight and policy action by the CFPB is needed.

Overdraft and Payday Loans Offered by Banks

Overdraft Loans

For many years, banks would extend overdraft coverage as a courtesy without a fee, but in the past two decades, they have switched to charging for this service. Today, these charges cost consumers billions of dollars.[49] The most common triggers of overdraft fees are small debit card transactions that could easily be denied at no cost when the account lacks sufficient funds.[50] Most institutions offer far lower cost alternatives called "formal" overdraft protection, such as contractual lines of credit or links to credit cards or savings accounts, but too many institutions aggressively steer customers to their highest cost overdraft coverage.[51] Research has shown that the majority of these fees are paid by customers who are least able to recover from them.[52] Over time, overdraft fees leave these already-struggling consumers worse off, less likely to be able to meet their ongoing expenses, and contribute to greater numbers of unbanked households.[53]

In November 2009, the Federal Reserve Board issued an "opt-in" rule, requiring that institutions obtain customers' consent before charging overdraft fees on debit card purchases and ATM transactions. This rulemaking helped raise widespread awareness about these fees. But the rule merely established a baseline protection for debit card and ATM overdraft fees that virtually every other credit product already enjoys: consent. Consent requirements for credit cards and mortgages have never removed the need for substantive protections in those areas.

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[49] *See* Leslie Parrish, *Overdraft Explosion: Bank fees for overdrafts increase 35% in two years,* Center for Responsible Lending (Oct. 6, 2009), *available at* http://www.responsiblelending.org/overdraft-loans/research-analysis/crl-overdraft-explosion.pdf.

[50] 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 25 (Jan. 25, 2007), *available at* http://www.responsiblelending.org/overdraft-loans/research-analysis/Debit-Card-Danger-report.pdf.

[51] Leslie Parrish, *Banks Target, Mislead Consumers As Overdraft Deadline Nears*, Center for Responsible Lending, (August 5, 2010), *available at* http://www.responsiblelending.org/overdraft-loans/researchanalysis/Banks-Target-And-Mislead-Consumers-As-Overdraft-Dateline-Nears.pdf.

[52] FDIC Study of Bank Overdraft Programs (Nov. 2008). In addtion, two CRL surveys, conducted in 2006 and 2008, found that 71 percent of overdraft fees were shouldered by only 16 percent of respondents who overdrafted, and those account holders were more likely than the general population to be lower income, non-white, single, and renters.

[53] Overdraft fees are a significant reason that individuals who had bank accounts at one time are no longer banked. *See* Dennis Campbell, Asis Martinez Jerez, and Peter Tufano, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*, Harvard Business School (June 6, 2008) (noting that virtually all involuntary bank account closures, when the financial institution closes a consumer's account, occur because the account became overdrawn an excessive number of times).

The Board's rule failed to address the fundamental substantive problems with the overdraft product: a balloon repayment paid directly out of the customer's next deposit, regardless of whether the repayment leaves the customer with enough funds to live on; fees out of all proportion to cost; the frequency with which the fees are charged; manipulation of transaction posting order to increase fees; and aggressive marketing and steering of high-volume overdrafters into high-cost programs.

The Board's consent rule did trigger a shift in the marketplace. The largest issuer of debit cards, Bank of America, stopped charging debit card point-of-sale overdraft fees altogether, joining Citi, which never has. But other issuers, large and small, aggressively marketed overdraft "opt-in," targeting the customers who generate the most fees and steering them to the highest-cost credit the bank offers.[54] As a result, although overdraft fees have decreased in the aftermath of the rule,[55] its impact has not reached those most likely to be trapped in debt as a result of the high cost of the product. Consequently, banks that have taken the high road so far are left vulnerable to pressure from investors to backslide.

Bank Payday Loans

Banks have more recently added another high-cost, short-term balloon repayment product to the mix: payday loans, in which banks deposit funds into the customer's account and repay themselves the loan amount plus the fee upon the customer's next deposit. Most banks offering this product charge a fee of $10 per $100 borrowed.

Consultants are actively pushing bank payday loans, touting dramatic increases in fee revenue. A recent industry webinar recommended that banks consider issuing high-cost, triple-digit APR loans,[56] and payday loan software is being marketed to banks with promises that, within two years, revenue from the product "will be greater than all ancillary fee revenue combined."[57] Bank payday programs are not pushed as a way to *substitute* for overdraft fees; rather, they promise to be an additional way banks to generate revenue. One marketing flier promises that offering the payday loan product will result in little-to-no "overdraft revenue cannibalization."[58]

[54] Center for Responsible Lending Research Brief, *Banks Collect Opt-Ins Through Misleading Marketing*, April 2011, *available at* http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/banks-misleading-marketing.html.
[55] A recent study by Market Rates Insight found that service fee revenue decreased $1.6 billion in the six months following the enactment of the opt-in rule. *See* http://www.marketratesinsight.com/Blog/post/2011/06/21/Reg-E-lowered-account-service-fees-by-2416-billion-since-enactment.aspx.
[56] Overdraft Rules, Part II: Interpreting the Ambiguous Guidance, Web Seminar, Banking Technology News, February 8, 2011.
[57] Fiserv Relationship Advance program description available at http://www.relationshipadvance.com/; *see also* Fiserv unveils Relationship Advance: *Full-service solution provides a safer, more cost-effective alternative to courtesy overdraft programs*, Press Release (Nov. 18, 2009), *available at* http://investors.fiserv.com/releasedetail.cfm?ReleaseID=425106; Jeff Horwitz, *Loan Product Catching On Has a Couple of Catches*, American Banker, Oct. 5, 2010.
[58] Ibid.

Bank payday loans have already caught on with several regional and national banks, who combined hold approximately 13% of total deposits at national banks and savings institutions.[59]

By calling their payday loan product a "direct deposit advance" or "checking account advance," banks attempt to differentiate it from other payday loans. But these distinctions are superficial at best and fiction at worst. Payday loans by banks have all the hallmark characteristic of those made by storefronts:

Comparison of Loan Features: Bank vs. Storefront Payday Loan		
	Bank Payday Loan	**Storefront Payday Loan**
Cost of typical loan	365 percent APR[60]	391 percent APR[61]
Repayment timing and amount	Due in full upon the customer's next deposit	Due in full at customer's next payday
Access to checking account funds for repayment	Bank repays itself automatically from the customer's next deposit, whether it is a paycheck or public benefits, like unemployment or Social Security	Lender has customer's post-dated check or electronic access to the customer's checking account
Underwriting borrower's ability to repay loan without funds provided by an additional payday loan	None	None

By making payday loans, banks undermine state law in states that do not permit payday lending by storefronts and federal law restricting payday loans made to military service members and their families.

Research that CRL plans to release in a report later this week demonstrates that bank payday lending leads to a debt trap, just as storefront payday lending does.[62] Our analysis finds that:

- **Bank payday loans are very expensive. At a cost of $10 per $100 (what most banks offering the product charge), they carry an annual percentage rate (ARP) of 365 percent based on the average loan term of 10 days,**

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[59] Based on total bank and savings institutions deposits of $9.4 trillion for 2010, as reported by the FDIC *Statistics on Depository Institutions*

[60] Most banks offering payday loans charge $10 per $100 borrowed, and our research has found that the typical loan term is 10 days; this equates to a 365% APR.

[61] A loan at the typical cost of $15 per $100, repaid in two weeks, equates to 391% APR.

[62] For our analysis, we used data from a demographically-representative consumer panel tracked by Lightspeed Research Inc. Our analysis included data for 614 checking accounts whose transaction-level online and offline banking account activity was electronically captured.[62] The dataset contains 12 months of data on 184,221 transactions. We identified instances of bank payday loan repayments within 55 accounts, and analyzed these for loan term, repayments, and other relevant factors

- **"Short-term" bank payday loans often lead to a cycle of long-term indebtedness; on average, bank payday borrowers take out 16 loans per year and are in payday debt for 175 days per year,[63] and**
- **Nearly one-quarter of all bank payday borrowers are Social Security recipients, who are 2.6 times more likely to have used a bank payday loan than bank customers as a whole.**

Recognizing the problems associated with payday lending, the FDIC cautioned banks about the practice in 2005 and advised that the longest a bank should keep borrowers in payday debt was 90 days over the course of a year.[64] Similarly, the National Credit Union Administration recently advised that small loans more expensive than 18 percent APR (and even then only up to 28 percent APR) should be limited to three every six months (equating to six per year).[65] Banks making payday loans are keeping borrowers trapped in payday debt, *on average*, for nearly twice as long as the *maximum* length of time the FDIC advised, and in many cases for much longer.

Banks claim to offer consumers "protections" against long-term use, specifically cooling-off periods (breaks between payday loans) and payment plans.[66] But even the storefront payday industry's "Best Practices"[67] call for limits on rollovers and encourage lenders to offer the option of an extended payment plan; traditional payday lenders easily evade these "protections" and these practices have not significantly reduced the debt trap that payday lending creates.[68]

Similarly, banks restrict customers from "renewing" their payday loans but allow back-to-back transactions. They also provide for cooling-off periods, but only after a customer has been in debt for many months. It's not surprising, then, that bank payday borrowers end up indebted for a significant portion of the year. Indeed, an insider at one bank offering payday loans admitted, "Many [borrowers] fall into a recurring cycle of taking advances to pay off the previous advance taken."[69] Some banks offer payment plans but only in limited circumstances, such as when a customer has already taken out three payday loans, or in exchange for an additional $50 fee.

The OCC recently proposed weak guidance addressing the bank payday loans. It suggests safeguards like those noted above, including permitting installment plans (while still, presumably, allowing the "default" arrangement to be a short-term balloon repayment) and

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[63] Mean statistics are 10.68 days per loan and 16.4 loans per person.
[64] FDIC Financial Institution Letters, Guidelines for Payday Lending, FIL 14-2005, February 2005
[65] NCUA, Short-Term, Small Amount Loans, Final Rule, Sept. 2010, http://www.ncua.gov/GenInfo/BoardandAction/DraftBoardActions/2010/Sep/Item3b09-16-10.pdf.
[66] *See*, e.g., *Biggest banks stepping in to payday arena: The big guns' entry into payday lending may finally bring fringe financial product out of the shadows and into the financial mainstream, despite howls of protest from consumer groups and the risk of tighter regulation*, Star-Tribune (Sept. 6, 2009) and Lee Davidson, *Do banks overcharge?*, Deseret Morning News (Jan. 22, 2007).
[67] *See* Best Practices for the Payday Advance Industry, Community Financial Services Association, *available at* www.cfsa.net/industry_best_practices.html.
[68] See Uriah King and Leslie Parrish, *Springing the Debt Trap: Rate cap are only proven payday lending reform*, Center for Responsible Lending (Dec. 13, 2007). In the vast majority of states that ban renewals or refinancing of existing payday loans, the borrower, lacking the funds to both repay the loan and meet other obligations, simply repays one loan and immediately takes out another. This is often called a "back-to-back" transaction, and the effect it has on the borrower's finances is identical to a renewal.
[69] David Lazarus, *120% rate for Wells' Advances*, San Francisco Chronicle, Oct. 6, 2004.

requiring cooling off periods. We are concerned that this guidance risks to legitimize payday lending by banks, instead of sending the message it should be sending—that banks should not be making payday loans.

Need for CFPB Action

In both the areas of overdraft and payday loans made by depositories, federal action is needed. On the overdraft front, the Federal Reserve Board started the process by requiring opt-in to overdraft programs, but other consumer protection is necessary, as abuses still abound. With respect to bank payday loans, the OCC and the FRB have thus far allowed banks to trap customers in exorbitant, long-term debt. A regulator focused on consumers' interests is needed to address this problem before it becomes more pervasive. The CFPB should take early action to stop banks from making payday loans.

IV. Conclusion

In summary, a robust CFPB that provides oversight of consumer financial services is necessary to the stability of the marketplace and the economy. Congress enacted the CFPB in reaction to federal prudential regulators' failure to halt the unsustainable lending practices that caused the foreclosure crisis, which then sparked the broader financial crisis. Today, proposals to weaken the CFPB threaten the Bureau's effectiveness, which could return us to the days of the Wild West in which risky and abusive practices were allowed to flourish unchecked, and in some cases even encouraged, when short-term safety-and-soundness concerns prevailed over consumer protection and long-term system risk concerns. With the transfer date just a few days away, it is imperative that we remember the lessons learned about the causes of the financial crisis and support the CFPB, which will bring much needed fairness, equity and transparency to the marketplace and help stabilize the economy.

Thank you for the opportunity to testify. I look forward to answering your questions.