Testimony of

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Written Testimony of Professor John Chung

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"Credit Cards and Bankruptcy: Opportunities for Reform"

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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