Bretton Woods, Inc.

Senate Subcommittee on Financial Institutions and Consumer Protection Hearing on:

"Consumer Protection and Middle Class Wealth Building in an Age of Growing Household Debt."
October 4, 2011

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OVERVIEW

Chairman Brown and Members of the Committee. My name is Michael Flores and I am CEO of Bretton Woods, Inc, an advisory firm in the financial services industry.

My firm is in the initial stages of a new study on the impact to the middle class's access to bank payments and credit facilities. We have completed studies over the last ten years on overdraft issues as well as the emergence of prepaid cards.

We demonstrated in the early 2000's that the cost of an overdraft was significantly higher that other sources of low dollar, short term credit. We have also shown that the prepaid card issuers with the most significant market share were on a par with basic checking accounts but are now a less expensive option available to the consumer.

Almost every day there is a news release of banks increasing their fees to consumers. At the same time we are hearing that banks have plenty of money to lend but are refraining from doing so.

The results of many studies over the last ten years, including our own studies[1], indicate that the majority of overdrafts were incurred by the segment of the consumer base that used free checking. Now that free checking is going away, consumers are closing their checking accounts and, as a result, losing access to this form of short term credit.

Our contention is that most banks are operating under a 20th century business model and have yet to adequately devise a 21st century model. Some of the issues involve the net interest margin squeeze banks have endured for the past fifteen years as well as recent regulatory changes that have significantly impacted banks' fee income sources. Those primary sources are overdraft fees and interchange fees. Other issues include the quickening pace of technology, the need to meet the expectations of the young consumers while still providing a service model with which the older customers are comfortable.

[1] http://bretton-woods.com/71501/index.html

This is what we refer to as the banks' legacy cost structure of delivering services in an analog world while building the infrastructure for a digital world.

Banks cannot profitably originate and underwrite individual small dollar loans. Out analysis indicates that $1,500 in the breakeven point using data from the FDIC Small Dollar Loan Program.

I have included a model in my written testimony for the committee's review.

Market driven entrants are able to leap frog the old model and build a cost structure to effectively deliver these services at competitive prices. We support the ability of banks and alternative service providers to have the ability to develop strategic partnerships or acquisitions to allow legacy banks be more competitive with entrepreneurial and market driven solutions

A key premise of this hearing is Consumer Protection. I am a true supporter of clear and concise disclosures so the consumer can make an informed decision. However, it is becoming apparent that the law of unintended consequences is alive and well. For example, the reduction in interchange fees to benefit the consumer, which was basically a business to business financial issue between the banks and the merchants, has inadvertently created a significant income redistribution from the consumers to the merchants in the form of higher bank fees to the consumer to lower costs/higher margins for the merchant.

Given this observation, the following are my concerns with the CFPB:

- Concentration of authority with, in my opinion, limited accountability. I believe that the bureau should be accountable to Congress as a check and balance, similar to other agencies.
- I see inherent problems in separating safety and soundness with consumer protection. Limitations on products or pricing beyond market constraints can potentially produce limitations of credit and access to mainstream banking that we are now starting to see. Further reductions in income sources to banks can have a significant impact to safety and soundness.
- Furthermore, the cost of compliance is increasing to a point where many small banks (under $1 billion assets) are limited in their ability to hire the professionals required.
- Finally, I believe the director should report to a board with a broad representation of the interested parties.

Thank you and I look forward to answering your questions.

SUPPLEMENTAL DATA

HISTORY OF BANKING OVERDRAFT FEES

In the 1980's, we advised banks to pay all checks from low dollar to high dollar so the bookkeepers would have fewer items to process. Fee income was not the factor it became in the late 1990's. During this time, banks were experiencing interest margin compression, traditional finance companies were exiting the business of offering small dollar, short term credits products (for which the demand did not subside) and technology became available to process checks presented against insufficient funds in an automated process. The result was the development of Courtesy Overdraft Programs that automated the decision process bank bookkeepers and branch managers have manually made for decades.

Given this new technology, banks started offering free checking. The amount of NSF and Overdraft items increased due to the limited options available for short-term/low dollar credit but the costs to handle these items were significantly less. Accounts that banks would not open in the past, they could now do so profitably.

We also changed the presentment order to pay large dollar checks first before the small dollar items. This was established was as a customer service. Paying the mortgage payment or rent or car payment first saved charges and embarrassment of "bouncing" those items. Secondly, when deciding to pay a check into overdraft was limited to checks (before debit cards and ACH became as prominent as they are today), this actually saved the customer money. When a bank returns a check unpaid, it charges the same fee as paying the check into overdraft. The depositing customer typically re-deposits that check that may result in another NSF fee plus any merchant fees or late fees or utility reconnect charges. In essence, paying a check into overdraft can be 1/3rd the ultimate cost of returning the check.

When banks extended the Courtesy Overdraft Program to low dollar debit card transactions, the customer ceased to receive value.

THE CASE FOR SHORT-TERM CREDIT ADVANCE LOANS

The point with the brief history of overdrafts is that when a customer opens a basic checking account, the bank will still make the pay or return decision on checks presented against insufficient funds (even if the customer "opts-out" of debit card and ATM overdrafts) and charge the fee, regardless of the decision. The result of many studies over the last ten years, including our own studies[2], indicates that the majority of NSF/OD charges were incurred by the segment of the consumer base that used free checking.

With the changing landscape of increasing checking account fees, many consumers of free checking are leaving banking for alternatives, including prepaid cards. The fact that some these consumers are out of mainstream banking while others are now paying more for checking accounts does not diminish the demand for low dollar short term credit.

Additionally with several state initiatives and the imposition of Regulation E (opt in requirement) to inhibit access to short term credit, consumers are still in need for this credit facility. The reason banks have started offering deposit advance loans is that individually underwriting small dollar loans is not economically feasible. As a practice, our firm has advised banks since the early 1990's to not originate loans under certain solar limits. The minimum limit found at many banks is now $1,000 for a consumer loan.

[2] http://bretton-woods.com/71501/index.html

Bretton Woods conducted a cost analysis to originate a small dollar loan based on the FDIC Small Dollar Loan Program. Our finding, as indicated in the following chart, show that the minimum loan amount is approximately $1,500 to breakeven.

	FDIC Quarterly Report, Small Dollar Loan Program 2010 Vol 4 No 2							
	Average SDL Loan Amount	Rate	Term	Monthly Payment	Total Payments	Fees	Interest Revenue	Total Revenue
Revenue	$ 724.00	13.09%	12	($64.70)	$776.36	$ 31.00	$52.36	$83.36
	Average SDL Loan Amount	Rate	Term				Interest Expense	Total Interest Expense
Funding Cost	$ 724.00	1.00%	12	($60.66)	$727.93	$ -	$3.93	$3.93
Net Interest Income								$79.43
Other Costs								
Capital Requirement	8.00%							
Return on Equity	12.50%							$3.69
Charge-Offs	$ 724.00	6.20%						$44.89
	Loan Officer *	Underwriter**	Processing***	Servicing****	Pull Through Rate *****			Total Other Costs
Salaries	$ 34.01	$ 25.01	$ 21.18	$ 17.74				$ 97.94
Applications Not Funded					49.25%			$ 49.71
Total Other Costs								$196.23
Net Profit (Loss) Per Loan								($116.80)
	Minimum loan amount to break even							$ 1,529.08

* Consumer Loan Officer I	$ 56,490.00 median salary plus 25% benefits = http://www.bls.gov/oes/current/oes132072.htm	$ 34.01 cost per hour. Assumes 1 hour per loan at 100% productivity	
** Consumer Loan Underwriter	$ 41,533.00 median salary plus 25% benefits = http://www1.salary.com/Consumer-Credit-Analyst-I-Salary.html	$ 25.01 cost per hour. Assumes 1 hour per loan at 100% productivity	
*** Consumer Loan Processor	$ 35,180.00 median salary plus 25% benefits = http://www.bls.gov/oes/current/oes_nat.htm#13-0000	$ 21.18 cost per hour. Assumes 1 hour per loan at 100% productivity	
**** Consumer Loan Servicing	$ 33,390.00 median salary plus 25% benefits = http://www1.salary.com/Accounts-Receivable-Clerk-salary.html	$ 20.10 cost per hour. ($33,390 X 1.25)/2353=	$ 17.14

*****Pull through rate
50.75% of all applications did not result in a closed loan although the time and costs of the loan officer and underwriter are still incurred

Notes:
The 2007 Cornerstone Report = Median 9 consumer loans originated per loan consumer loan officer per month, 93 consumer loans underwritten per loan consumer loan underwriter per month and 145 consumer loan applications processed per comusmer loan processing FTE per month. Use of these benchmarks would
2007 Cornerstone Benchmark Analysis = 2,353 consumer loans serviced per servicing FTE

Interviews with participants of the SDL program indicate that these loans are unprofitable. An excerpt from the FDIC report[3] shows:

- "Nevertheless, as a general guideline, pilot bankers indicated that costs related to launching and marketing small-dollar loan programs and originating and servicing small-dollar loans are similar to other loans. However, given the small size of SDLs and to a lesser extent NSDLs, the interest and fees *generated* *are not always sufficient to achieve robust short-term profitability (emphasis added)*. Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products."

The average loan amount for short term credit is approximately $300[4] according the Center for Responsible Lending.

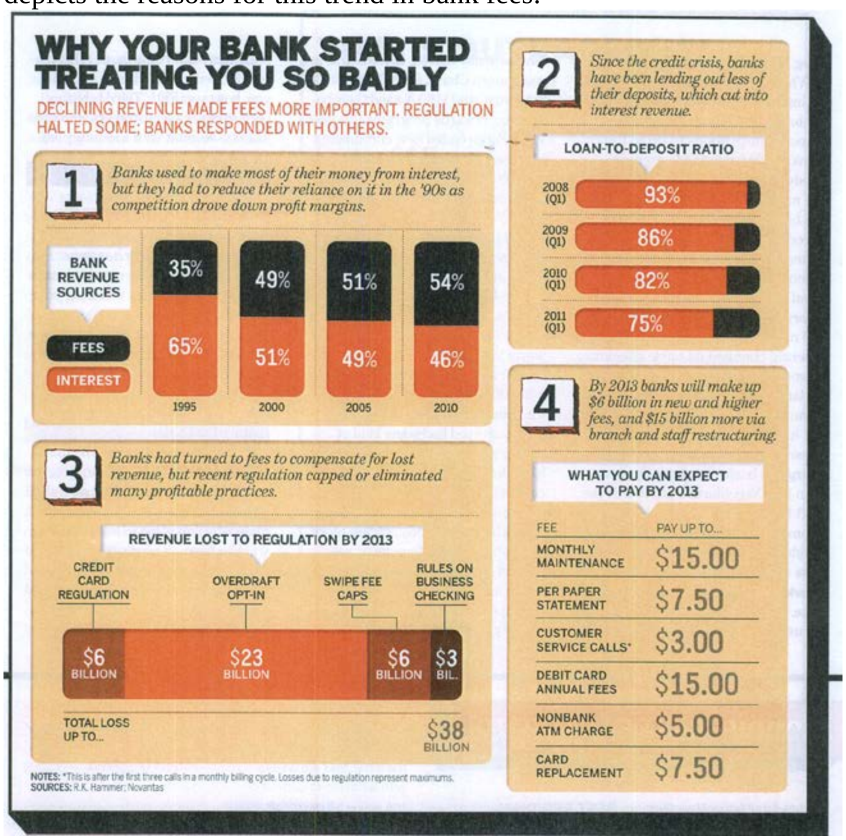
Given the average FDIC Small Dollar Loan program loan amount is $724 and our estimate that it takes a minimum $1,500 for a bank to breakeven on a consumer loan and the demand for a short term loan is $300, *what are the options available to this consumer?*

[3] http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf
[4] http://www.responsiblelending.org/payday-lending/research-analysis/payday-loan-inc.pdf

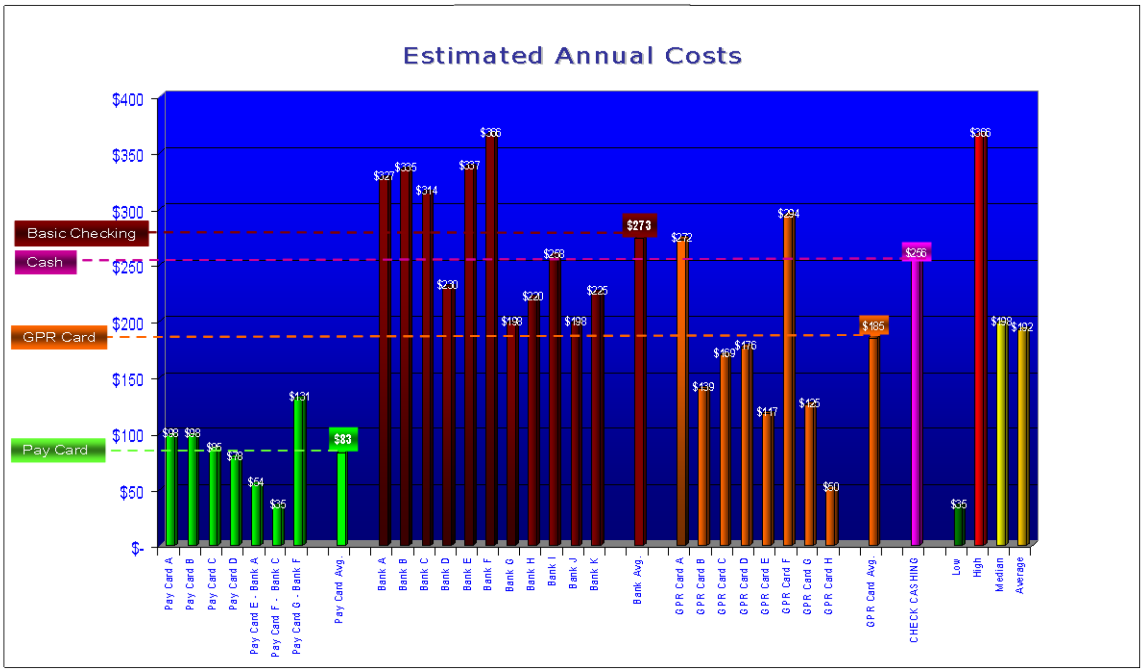
The market currently has options for unanticipated short-term credit needs in the form of Overdrafts. There are also banks, credit unions and Alternative Financial Services providers that have product for anticipated short term credit needs.

As with all products, features need to be weighed against price. The typical bank or credit union product has a slightly lower price point for a low dollar loan but require the applicant be a customer for a period from one month to four months and have no other delinquencies with existing credit products. Many consumers who have a need for this credit may not qualify for a checking account because of previous issues and reporting to Chex Systems. Others with existing accounts have or are considering closing their checking account due to higher fees being assessed.

A recent article from Money Magazine, *Get a Fair Shake, Not a Shake-down,* dated September , 2011, depicts the reasons for this trend in bank fees:



Our own analyses of the cost of checking accounts compared to prepaid cards and check cashing using the Consumers Union standard transaction profile[5] in August of this year shows:



The bank costs are now understated given the recent new from Bank of America and Citibank.

5 http://www.consumersunion.org/pub/core_financial_services/014300.html