Statement of
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and
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On
Protecting Social Security Beneficiaries from Predatory Lending
And
Other Harmful Financial Institution Practices
before the
Subcommittee on Social Security of the Ways and Means
Committee; U.S. House of Representatives
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Chairman McNulty, Ranking Member Johnson, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning issues related to the garnishment of federally protected benefit payments. Federal benefit payments are an important -- and often the sole -- source of income for many Americans, including senior citizens, veterans and the disabled. The FDIC is aware that actions that limit access to these funds result in hardship and expense for benefit recipients. The FDIC is committed to ensuring that recipients of federal benefits receive the full protection of those benefits to which they are entitled.

The use of garnishment as a debt collection tool raises many issues when it is applied to accounts containing federal benefit payments. When financial institutions receive a garnishment or attachment order against an individual, they customarily freeze that individual's deposit accounts, often not knowing that the accounts might hold the proceeds of benefit payments which generally are exempt by law from garnishment. While the funds eventually are released, often through protracted legal processes, the customer can suffer financially in the meantime.

In my testimony, I will discuss the current legal protections applicable to federal benefit payments and the interplay between federal law and state civil procedures for garnishment and attachment to satisfy unpaid debts. In addition, I will describe actions the FDIC and the other federal banking agencies are taking to address the issues surrounding garnishment, as well as recommendations for achieving a comprehensive resolution of this issue. Finally, my testimony will discuss additional practices related to the distribution of federal benefit payments that we are closely examining because of their effect on beneficiaries.

Background

While garnishment procedures vary from state to state, funds in an account at a financial institution generally may not be seized without a court order. After receipt of

the court order, pursuant to the requirements of state law, the financial institution must place a "hold" or "freeze" on the debtor's account. In many states, financial institutions are potentially liable for any funds withdrawn by a debtor from an account after a freeze or hold has been placed upon it pursuant to a court garnishment order.

As a result of a freeze or hold being placed upon an account, the debtor account holder typically is not able to withdraw money from the account or draw checks upon it. State garnishment laws usually provide that notice must be given to the debtor that an account has been frozen or has had a hold placed upon it. Several jurisdictions require a formal hearing at which time the debtor is given an opportunity to explain why frozen funds should not be seized or garnished. It is at this juncture that debtors typically raise the defense that the funds that have been frozen are protected from garnishment by various exemptions.

Under federal law, several types of federal benefit payments are protected from garnishment or attachment by creditors. These include Social Security benefits, Supplemental Security Income (SSI) benefits, Veterans Affairs (VA) benefits, civil service retirement benefits, military retirement annuities, and railroad retirement benefits.1 While each type of benefit is protected under its own respective statute, these laws typically provide that the benefits are not subject to execution, levy, attachment, garnishment, or other legal process.2 In addition, state laws often provide for certain types of funds to be exempt from garnishment, such as private pension payments.

The interplay between state garnishment law and federal benefit exemptions is complex and raises a number of legal and practical issues. Court garnishment orders often tend to be broadly worded with no reference to exemptions under either federal or state law. Moreover, exemptions to garnishment may have their own exceptions. For example, while Social Security benefits generally may not be garnished, they may be garnished or attached pursuant to a valid court order to collect debts related to alimony or child support. This makes it difficult to determine whether funds in an account that otherwise would be exempt from garnishment under federal law should still have a hold or freeze placed upon them.

The intricate relationship between state and federal requirements with respect to garnishment of federal benefit funds is made even more problematic by state and federal case law that provides little guidance on how to handle such issues. For example, a Second Circuit court decision upholds New York's civil procedure law requiring a freeze on all funds held in garnished accounts, including exempt federal benefits, finding that the beneficiaries' due process rights were not violated by this requirement because the statute provided beneficiaries with notice and an opportunity to prove that the funds were exempt.3 This holding is being questioned in ongoing litigation in a New York federal district court. In the litigation, the district court judge is open to considering the claim that New York civil procedure violates the beneficiaries' rights to due process by failing to treat a federal exemption for benefit funds as a bar against placing a freeze or hold against the funds, even if imposed pursuant to a state court garnishment order, when the relevant funds were deposited electronically.4

An additional complicating factor in the relationship between state garnishment procedures and Social Security benefits is the Social Security Administration's (SSA) interpretation of the garnishment exemption. The SSA recommends to beneficiaries that "[i]f a creditor tries to garnish your social security check, inform them that, unless one of the five exceptions apply, your benefits can not be garnished."5 In other words, the exemption provision is to be treated as a defense to be raised by a beneficiary after a freeze or hold has been placed on an account pursuant to a garnishment order, rather than a bar against the imposition of the freeze or hold in the first place. Veterans Affairs staff have stated that they have a similar interpretation of their counterpart provision exempting VA benefits from garnishment or attachment.

In the face of this uncertainty, many financial institutions conclude that the safest and most prudent course of action is to comply with the requirements of state garnishment orders and to leave it to the depositors to establish whether funds in their accounts are exempt from garnishment under federal law -- and wait for the state process and courts to determine entitlement to the funds. This is especially true in light of decisions where the recipient of a court order has been held in contempt for not complying with the order even if it was subsequently found invalid.

Issues

The application of state and federal law regarding garnishment raises a number of issues for benefit recipients, banks and regulators.

Many benefit recipients are unaware of the exemption

State garnishment laws generally contemplate a process that places the burden on benefit recipients to claim applicable exemptions. However, under the framework set up by many state laws, benefit recipients are often unaware of the exemptions available to them. The court order may not make reference to any potential exemptions and the benefit recipient may have limited access to legal advice. Too often, benefit recipients do not understand their rights under the exemption or their need to raise a defense during the garnishment process. Clarification of these rights and responsibilities is clearly needed. To effectively provide benefit recipients with an opportunity to exercise their rights, information regarding possible exemptions should be provided contemporaneously with the notification of the garnishment order.

Current procedures provide inadequate protection for benefit recipients

Even if a benefit recipient is aware of available exemptions, existing garnishment procedures often provide inadequate protection for benefit recipients. State garnishment laws are generally designed to rely on a process that provides beneficiaries with notice and an opportunity to claim that some or all of their funds are exempt from a garnishment order after it is issued and the beneficiaries' funds are frozen by the

recipient bank. However, beneficiaries can suffer financial hardship that results from losing access to the exempt funds during the garnishment process.

Freezing an account that may represent a beneficiary's principal, if not exclusive, source of income can have severe consequences. The recipient may be unable to perform essential financial functions, such as paying rent or making a mortgage payment. In addition, account holders may be subject to fees and penalties associated with the freeze, such as fees for placing a freeze on the account, overdraft fees, and penalties for returned items. These fees and penalties can be substantial and can cause additional hardship. Even when the garnishment is properly resolved, affected accounts may be significantly depleted by fees and penalties.

Garnishment orders are often broad

Many state court orders are broad and encompass all funds. These orders may specify that the financial institution is to freeze and then hold all funds in the benefit recipient's account, even though the state statute recognizes particular exemptions including federally protected benefit funds. In short, when an institution receives a garnishment or attachment order affecting deposit accounts, it faces difficult choices that implicate both its customers' interests and its own legal responsibilities. A bank faces a legal risk if it fails to take action under state creditor laws and/or court issued garnishment orders. Under some of these laws, a bank can be held liable for the entire amount of a debt that a creditor is seeking to collect if the bank fails to comply with a garnishment order.

The application of garnishment exemptions to commingled funds is difficult

The accounts of many recipients of federal benefits do not solely contain funds from federally protected sources such as Social Security or VA benefits. Instead, such funds are mingled with funds from other, non-exempt sources such as private employment. Commingled exempt and non-exempt funds are essentially indistinguishable. It is difficult to trace such funds in an account and to determine their source of origination. Because of the difficulty in ascertaining whether funds in a garnished account are entitled to the protection of a federal exemption, it is often easiest for banks to freeze the entire account and have the court apportion the funds in the account between those that are exempt and those that are covered under the garnishment order.

FDIC Initiatives

The FDIC recognizes the important issues raised by the interaction of state and federal law with regard to garnishment and the impact the current situation has on recipients of federal benefits, such as social security and SSI. The FDIC is committed to addressing this important issue, and Chairman Bair and Vice Chairman Gruenberg have directed us to work with the industry, consumer groups and our fellow regulators to develop solutions. In August 2007, Chairman Bair proposed that the Federal Financial Institutions Examination Council (FFIEC) Taskforce on Supervision form a working group to address garnishment of exempt public benefit payments. The FDIC played a

leadership role in forming an interagency working group which includes the banking agencies and representatives from the Office of Management and Budget (OMB), SSA, VA, and the Department of the Treasury.

The interagency working group considered the merits of a number of policy options. Although the FDIC and other bank regulators currently lack adequate legal authority to effectuate a comprehensive solution to the issues raised by garnishment, we initially offered a proposed list of practices for banks to use as guidelines when faced with processing garnishment orders. The proposed guidance was published in the Federal Register on September 28, 2007, and afforded a 60-day period for public comment. After receiving 77 public comment letters, it was clear that the best practices guidance would not provide a sufficient response to the issue and that regulatory or legislative action was necessary to address the concerns of both the financial institutions and consumers. The proposed guidance, however, sensitized financial institutions to the issues regarding garnishment and sought their more active involvement in the resolution of the issues surrounding garnishment orders.

At the beginning of this year, the banking agencies and the benefit paying agencies met with representatives from the banking industry. The bankers described detailed procedures used to process garnishment orders, as well as complexities they encounter as a result of multiple recordkeeping systems and varying state laws and civil procedures. The agencies also met with consumer advocacy groups to discuss the impact of garnishment orders on elderly and disabled consumers and their perspective on possible solutions to the garnishment issues. At the same time, the FDIC was taking steps to increase public awareness of the exemptions from garnishment that are available to benefit recipients under federal law.

Possible Solutions to Address Garnishment of Exempt Federal Benefits

The FDIC's goal in developing solutions to address many of the significant issues raised by garnishment of federal benefits has been to find approaches that will address the legitimate interests of both benefit recipients and their financial institutions. After consulting with the other agencies, consumer groups and the banking industry to build a consensus on an optimal solution to address these issues, the FDIC would suggest consideration of two alternatives.

SSA, VA and the Treasury Department have authority to promulgate rules under their current statutory authority. As the agencies responsible for implementation and interpretation of these benefit programs, they are in the best position to address the garnishment exemption issue. Rulemaking by these agencies on this issue would provide bank regulators with legal authority to enforce such rules under current enforcement authority.

The FDIC suggests that the potential solution could be similar to statutes currently in effect in Connecticut and California.6 The Connecticut law directs a bank that has received a garnishment order to leave the lesser of $1,000 or the amount on deposit on

the date the garnishment is served if "readily identifiable" exempt funds have been deposited by direct deposit into the account during the 30-day period prior to service of the garnishment. Under the California law, when a civil garnishment order is served on a California financial institution, if the deposit account receives direct deposits of Social Security benefits or other specified types of public benefits, the account enjoys an automatic exemption, without the account owner having to seek a stay of the order, subject to certain dollar limitations set forth in the law:

- $1,225 where one depositor is the designated payee of a directly deposited public benefits payment other than Social Security benefits payments.
- $2,425 where one depositor is the designated payee of directly deposited Social Security benefits payments.
- $3,650 where two or more depositors are the designated payees of directly deposited Social Security benefits payments.

These approaches give the customer access to funds while the dispute is resolved and provide a comparatively simple, clear rule for banks that receive garnishment orders. The FDIC believes that such an approach makes sense and should be applied nationwide to provide access to vital funds for beneficiaries of exempt benefits. We also believe that it is important that beneficiaries receive prompt notice with clear information regarding their rights in getting their exempt funds unfrozen as quickly as possible.

The issue of commingling of exempt and non-exempt funds similarly could be addressed by a statutory provision mandating that certain minimum amounts in such accounts could not be frozen, garnished, or attached so that subsistence funds would remain available to account holders while their legal rights are being resolved.

Another alternative would be for Congress to amend section 207 of the Social Security Act and similar statutes.7 However, it appears that ample authority exists under current law to address the issues surrounding garnishment through rulemaking.

The FDIC will continue to work with the benefit-paying agencies and other federal agencies to improve the garnishment system to ensure the fair treatment of beneficiaries through a structure that provides clear guidance to financial institutions and state judiciary systems.

Payday lending issues

The FDIC has long been troubled by the impact on consumers of costly short term credit, such as payday lending. Typically, these loans are characterized by small-dollar, unsecured lending to borrowers who are experiencing cash-flow difficulties and have few alternative borrowing sources. The loans usually involve high fees relative to the size of the loan and, when used frequently or for long periods, the total costs to the borrower can rapidly exceed the amount borrowed. Consumers using this product typically have bank accounts because payday lenders generally require a post-dated check from the consumer for the loan's repayment.

The FDIC has issued a series of guidance statements on this type of lending. The most recent guidance, issued in 2005, discourages institutions from repeatedly renewing short-term, high-cost loans, instead encouraging institutions to offer customers alternative longer-term credit products that more appropriately suit the customers' needs. FDIC guidance had the effect of essentially stopping FDIC-supervised institutions from making high-cost payday loans.

Further, in March of this year, the FDIC launched a two-year small-dollar loan pilot program to identify effective and replicable business practices to help banks incorporate affordable small-dollar loans into their other mainstream banking services. Lending in this program follows in large measure the Guidelines on Affordable Small-Dollar Loans issued in June, 2007. These guidelines provide a means to enable insured institutions to better serve an underserved and potentially profitable market while helping consumers avoid, or transition away from, reliance on higher-cost payday type loans.

The movement to electronic funds transfer and direct deposit of benefit payments in many ways has been a favorable development. It can provide added convenience and security for benefit recipients over the traditional payment of benefits by check. However, it can also enable payday lenders, check cashers and pawn shops to profit from consumers who lack traditional banking relationships (such as a checking account in the usual payday lending relationship) and provide a means to control beneficiaries' flow of funds. In order to electronically transfer benefit funds, a bank routing number is required. As such, a cottage industry has grown up around electronic benefit payments that allow payment distribution firms to use the banking system to capture control of consumers' benefits.

Reports have described situations where unbanked individuals, including recipients of federal benefits, have completed Standard Form 1199A ("Direct Deposit Sign-up Form") that authorizes payment distribution firms, check cashers, pawn shops and payday lenders to deposit their funds in a bank account that these firms exclusively control. These relationships are often created by a complex web of financial participants, including ultimately the depository institution where the funds are held. Consumers who receive their federal benefits payments through these processes may also be subject to unnecessary fees that could be avoided through simpler payment methods, such as the direct deposit of their benefits into a personal account with the beneficiary's own bank.

The FDIC is very concerned about bank involvement and has been actively reviewing these relationships and practices. At this time, it appears that a limited number of financial institutions supervised by the FDIC, as well as other federal and state banking regulators, are involved in these arrangements. We are currently investigating to determine the extent and type of the relationships between FDIC-supervised financial institutions and payment distribution firms, check cashers, pawn shops, and payday lenders. These relationships raise a number of issues, including appropriate disclosures to consumers, the ability of consumers to maintain control over their funds, compliance with various federal and state consumer protection standards by financial institutions

and whether the accounts are properly structured to qualify for deposit insurance protection. If warranted, the FDIC intends to use our supervisory and enforcement tools to ensure the protection of consumers.

While we continue to look at FDIC-supervised institutions' roles with respect to the benefit payment distribution mechanism, which is usually a depository relationship, we also support the SSA's willingness to address the challenges from the benefits distribution perspective. Recently, the SSA issued a Notice of Request for Comments on the use of master/sub accounts for the payment of benefits. In the Notice, the SSA indicated that it anticipates changing its current procedure in light of concerns about how high interest lenders are using this account procedure. With the information being gathered from the Notice and from our own review, the FDIC stands ready to provide any assistance to SSA that it might request and to implement any restrictions on these accounts that SSA might establish.

Also, we believe that with the introduction of the Direct Express Treasury debit card program, participating beneficiaries will maintain control of their benefit funds, thus, preventing the redirection of benefits to potentially unscrupulous entities.

Conclusion

Congress intended that Social Security and other federal benefits not be subject to garnishment, except in certain specific cases. However, it is the freezing of funds that causes significant harm to recipients of federal benefits programs. Moreover, the garnishment process is primarily controlled by state law. As currently implemented, this process causes hardship for beneficiaries who lose access to their primary source of funds while they wait for a legal determination of their rights, and who are assessed fees even if they demonstrate that their funds should be protected. Regardless of the outcome of the garnishment proceeding, these account holders suffer financial harm.

The FDIC is committed to helping solve the garnishment issue. We have engaged consumer groups, the banking industry, and other interested federal agencies in trying to achieve a workable solution. The concerns about garnishment can undercut the attractiveness of an insured bank as a place for people to utilize financial services, such as checking, savings and direct deposit. The resolution of this issue is important to the achievement of our broader efforts to encourage consumers to be economically empowered through the banking system.

The FDIC also is very concerned about bank involvement in practices that facilitate high cost activities, such as payday lending. We are particularly reviewing how these practices can transfer control of a consumer's benefits to a third party. If warranted, the FDIC intends to use our supervisory and enforcement tools to ensure the protection of consumers.

The FDIC will work with Congress and our colleagues at other agencies to find a solution that truly addresses these issues. This concludes my testimony. I would be happy to answer any questions that the Committee might have.

1 Some Federal laws protecting benefit payments from garnishment orders include 42 U.S.C. 407(a); 42 U.S.C. 1383(d)(1); 38 U.S.C. 5301; 5 U.S.C. 8346(a); and 45 U.S.C. 231m(a).

2 For example, Section 207 of the Social Security Act provides that, with certain exceptions, moneys paid or payable as Old-Age, Survivors, and Disability Insurance (OASDI) benefits, are not "subject to execution, levy, attachment, garnishment, or other legal process." 42 U.S.C. 407.

3 McCahey v. L.P. Investors, 774 F.2d 543, 550 (2d Cir. 1985).

4 Mayers v. New York Community Bancorp, Inc., 2006 WL 2013734 at * 6-7 (E.D.N.Y. 2006) and 2005 WL 2105810 at * 11-14 (E.D.N.Y. 2005) (decisions not reported in F.Supp.2d).

5 See, e.g., "Direct Deposit: Frequently Asked Questions," Social Security Online, http://www.socialsecurity.gov/deposit/DDFAQ898.htm.

6 See CONN. GEN. STAT. 52-367b (2007); CAL. CIV. PROC. 704.080 (2004).

7 Similar amendments could be made to the law regarding VA benefits and other legally protected federal benefit payments.

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