Bank of America

Testimony of Bruce Hammonds
President, Bank of America Card Services

Before the Senate Permanent Subcommittee on Investigations

December 4, 2007

Good morning Chairman Levin, Senator Coleman and members of the subcommittee. My name is Bruce Hammonds, and I am President of Card Services for Bank of America. This is my second appearance before you. On my last appearance I submitted substantial testimony for the record, part of which focused on the topic for today. I appreciate the opportunity to expand upon my previous testimony to describe further the modern credit card industry. In my statement, I would like to stress four main points:

- Credit cards provide consumers extraordinary benefits, giving them a safe and ready form of payment for use throughout the world, with additional dividends such as cash or in kind rewards for using the card. And credit cards allow consumers to borrow money – often, interest free – at any time in amounts of their choosing, and to repay it on schedules of their choosing.

- In response to consumer demand and competition, risk-based pricing has emerged as a core element of this system, ensuring credit is available to more consumers than ever, while reducing credit costs for the least risky borrowers.

- Within a competitive marketplace, issuers employ different risk-based pricing strategies, and consumers make informed choices among issuers. Consumers are best served by such a free market. They are also protected by the highly-regulated environment in which card issuers operate.

- Customer satisfaction is paramount at Bank of America, and our pricing practices and initiatives are designed and continuously revisited with the customer view in mind. In 2007, only 6.5% of our total accounts had an increase in interest rate due to default and/or risk-based pricing, 25.9% had a decrease in interest rate and 67.6% had no change. In other words, 93.5% percent of our customers now have the same or lower rate than they did at the beginning of the year.

I will address each of these points in turn.

Credit Cards Provide Consumers Choice and Flexibility

While we continually look for ways to do more for our customers, it is important to reflect on just how far we have come. For the average consumer, credit cards have emerged as a safe and convenient alternative to cash and are accepted more places than checks. They facilitate internet shopping. The wide acceptance of cards provides instant benefits to merchants, and many small businesses use credit cards as a primary source of working capital. This activity fuels economic growth.

In the 35 years I have been in this business, I have watched innovation and competition produce ever-increasing benefits for consumers. Consumers today, for example, can use their cards to get cash from ATMs or make purchases throughout the world. And thanks to our security protections, they do so without risk of substantial loss from fraud or identity theft. Our monthly and annual statements allow consumers to track and manage their spending throughout the year. And most cards – including our recently introduced BankAmericard – provide consumers with points that can be redeemed for cash, travel or other tangible benefits.

Competition has driven innovation in pricing, as well. Over the years, credit card companies developed sophisticated modeling capabilities that use internal data combined with credit bureau information to predict future performance and price loans accordingly. Such innovations helped lenders manage risk better, but they also provided benefits to consumers. Whereas card companies previously offered one fixed rate for all borrowers, regardless of risk, and charged annual fees; today borrowers have multiple rate options, and the annual fee is all but extinct. The GAO documented these benefits last year as part of an exhaustive study.

In addition, risk-based pricing has democratized access to credit, providing more consumers with credit than ever before. Sophisticated internal credit scoring and risk management practices allow us and other banks to provide cards to customers whose credit scores previously might have disqualified them from receiving bank loans or other traditional forms of credit. Moreover, credit cards remain an important entry point for those consumers who are establishing credit for the first time.

Risk-based Pricing is Critical to the Modern Credit Card System

With all of their benefits for consumers, credit cards present corresponding challenges for card issuers. Credit cards are open-end, unsecured loans that are considerably more risky than other forms of traditional consumer loans. The unique characteristics of cards present unique risks. For example:

- Customers maintain their credit lines indefinitely, and can drawdown and repay them as they choose.

- Customers' financial health changes and some become riskier over time. Lenders retain that risk, but unlike a mortgage or an automobile, there is no security to fall back on when a borrower defaults.

- These riskier customers impose considerable credit losses on our bank. To illustrate, the total amount we lose to customer default is considerably greater – 3 times as much – than the amount we collect in late and over-limit fees.

Risk-based pricing has allowed the industry to navigate these particular challenges while still providing customers the flexibility they demand. Although competing major card lenders structure their pricing mechanisms in different ways (I'll talk more about this in a minute), we *all* engage in some form of risk-based pricing. This universal industry practice is founded on one principle on which we all agree: Customers who show increasing signs of risk should pay more than customers who do not, in order to compensate for that risk.

The fact that over one-third of our accounts – those which represent the least risk -- pay nothing at all for the benefits of their cards, is tangible evidence this principle works. Using their cards as payment tools rather than revolving debt instruments, these customers pay their balances in full each month and receive the benefits of "grace" periods. Making interest-free, unsecured loans is not a profitable business. But it illustrates risk-based pricing is better for the average consumer than prior pricing systems. In the old days, less risky consumers subsidized rates of riskier ones; there was less of a relationship between risk and price. We believe most consumers would not like to see the industry go back to that state.

Some have characterized risk-based pricing as unfair, because consumers who are re-priced are not getting the rates they originally bargained for. Taken to its extreme, this view would prohibit lenders from making any pricing changes after a credit card is issued, regardless of how a borrower's risk profile changes.

If we could identify with certainty at the outset of each card relationship the customer who would be the least risky over time and the one who would default, we could price all customers appropriately at the time we open the account. But this is not reality.

- We do an excellent job evaluating the credit risk when we open an account, but we will never be able to project into the future whether one cardholder ultimately will become riskier than any other cardholder; and

- Within a portfolio of card relationships, most of which extend for many years, the risk profiles of some customers will change, and some will become riskier.

Consequently, in order to maintain an appropriate balance of risk and reward, consistent with principles of safety and soundness, card issuers continually monitor their portfolios and re-price according to customer behavior. Before risk-based pricing, card companies simply charged all cardholders more at the outset. And credit underwriting standards were more conservative, because less information was available, and standards were less predictive and applied only at application.

As it evolved from this static, “one-size-fits-all” pricing system, the industry adopted a more dynamic approach to credit management, continuously monitoring customer behaviors and periodically re-pricing small, riskier segments of the population using highly-predictive statistical models. The result has been lower prices for the average consumer and greater credit availability. While not perfect, we believe this dynamic approach to credit management, which pinpoints risk and ensures it is priced accordingly, is fairer to the average consumer.

I must emphasize that risk-based pricing is not simply an optional feature of credit card agreements. It is the core of the modern credit card system. Attempts to interfere with the market here – to return to practices from which the industry has already evolved - will inevitably result in less credit being offered and to fewer people, at higher interest rates and with new fees.

Now, let me describe how risk-based pricing works in greater detail. With risk-based pricing, we assess each borrower’s potential risk at the time we establish a new account and throughout the life of the card relationship. We charge our riskier customers more – through a higher interest rate at the beginning of the account or based on customer behavior, or as a consequence of risky behavior such as paying late. In short, while the customer retains the right to close the card account and transfer any balance at any time to a competitor that offers a better deal, we retain a corresponding right to increase the cost of credit when the customer demonstrates higher risk. Moreover, even the riskiest customer can preserve their existing rates by simply not defaulting on their loans and rejecting proposed rate amendments. The marketplace effectively constrains our pricing, in no small part because customers can, and do, react to a pricing change by paying off or transferring their accounts at any time.

New Accounts. When a customer applies for a credit card, we assess his or her ability, stability, and demonstrated willingness to repay debts, in determining the appropriate level of credit and price. Sophisticated automated systems and experienced lending analysts make lending decisions based on the borrower's current financial situation and past credit experience. For customers with other accounts at Bank of America, we also consider their experience with us. All major credit card companies consider external or "off-us" credit experience when extending credit to new customers. Based on this information, a new customer is assigned an initial credit limit and a contract interest rate.

Periodic Portfolio Risk Reviews. We periodically review accounts of existing customers to make sure pricing and credit limits remain appropriate based on the borrowers' current circumstances. Our experience has shown that customers who exhibit certain behaviors are more likely to default on their credit card loans. Such behaviors include their performance with us – making only minimum payments for a long time or taking large cash advances —and off-us behavior – like poor payment history, taking out numerous loans, using substantially all of the credit available to them, or defaulting on loans with other lenders.

If we detect a change in these types of behaviors, a loan may be re-priced, but only after appropriate notice and opportunity to opt-out has been provided to the customer. When a loan is re-priced in this manner, the new rate applies to all outstanding balances, not just new purchases. We apply the new rate in this way because it is the whole balance that is at risk for the bank.

The customer always has a right to say "no" to such an increase. The customer will then repay any outstanding balance under the original terms, including the original interest rate, although he or she must discontinue using the card. That seems right to us.

Let me give you an illustration of how this works: A customer opened an account, and she had a FICO score of 738, which is quite strong, and a low proportion of revolving debt to total income. When we reviewed the account four years later, her FICO had dropped over sixty points to 674, which is more marginal, and she had accumulated more outstanding revolving debt, most of which was with other creditors, so that revolving debt to total income was about 80%. Moreover, she was using her account with us and making payments in a manner that suggested greater risk. In this circumstance the customer's risk profile no longer qualified her for the low rate she was originally approved for, because our risk models told us there was a significantly greater risk that she would default on this account.

Customer Defaults. Under the industry-wide practice of "default re-pricing," higher contractual interest rates will apply in the event customers make late payments or exceed their credit limits, both of which are signs of risky behavior. At Bank of America, it takes *two* such defaults in 12 months to trigger a re-pricing and, even then, we frequently use our discretion not to re-price. This is commonly referred to as "on us" re-pricing and is the most common form of re-pricing at Bank of America. We use two triggers rather than one because we believe that is far more indicative of a change in risk rather than an inadvertent mistake by the customer. Even then, only a minority of those who trigger a default actually get re-priced. And it is a very small percentage of our portfolio that is subject to default re-pricing each year.

Default rates are clearly and conspicuously disclosed in marketing materials, on credit applications and card agreements. Moreover, in 2008 we expect that all Bank of America customers will have the opportunity to benefit from a "cure." That means customers who have been subject to increased default rates will automatically be "cured" to lower rates, provided they make six consecutive on-time monthly payments and do not go overlimit.

Effect on Customer Behavior. Experience shows that many customers who are re-priced often adopt better card management practices: they make more than the minimum payments; pay on time; and stay within their credit limits by charging less following a re-pricing. So from this perspective, re-pricing practices can encourage more responsible financial behavior.

Within a Competitive Marketplace, Issuers Employ Different Pricing Strategies.

I'd like to discuss briefly the differences that exist among issuers in their methods of risk-based pricing, and the unintended consequences that would surely result from attempts to eliminate these differences and harmonize industry practices.

All issuers use risk-based pricing, for the reasons I described earlier. But as part of this highly competitive industry – which produces innovation and consumer benefits -- issuers take different approaches to risk-based pricing, based on their perceptions of customer behavior and their need to earn appropriate returns for the risks they incur, consistent with principles of safety and soundness.

Today, there are two primary forms of risk-based pricing related to customer behavior: (1) contractual defaults that may trigger automatic increases; and (2) behavioral re-pricings with notice and opt-out, for consumers who exhibit risky behaviors that substantial experience has taught us is highly predictive of future delinquency and charge off. Within this basic framework, industry competitors take a myriad of approaches.

With respect to contractual defaults, for example:

- Some issuers use "hair trigger" defaults – increasing a customer's rate based on a single default. Bank of America allows *two* defaults before it re-prices.

- Issuers define "defaults" differently. Bank of America considers only late payments and going over limit as defaults; while others include bounced checks, even if a valid payment has also been made.

- Some issuers offer a "cure" to a lower rate with good payment behavior, as Bank of America proposes to do; others do not.

- To our best knowledge, all issuers, including Bank of America, apply default re-pricing to both new and existing balances.

- And different issuers choose to default re-price their portfolios more or less aggressively. As I mentioned before, only a minority of accounts that trigger default pricing at Bank of America actually get re-priced.

With respect to behavioral re-pricing, which seems to be the current focus of this committee, industry practices also vary. Bank of America maintains a 12-month stand-off on its periodic risk reviews – no account that has been so re-priced will be subject to a periodic risk-based re-pricing for at least 12 months.

As these hearings demonstrate, issuers have different perceptions of how to appropriately address portfolio risks and the overall customer experience. *We* believe that limited default re-pricing, combined with periodic off-us re-pricing – particularly when customers have advance notice and the right to say "no" to the "off-us" re-pricing – is not only fair to customers, but consistent with safety and soundness. In our experience – and our experience is considerable – a customer bouncing a check with us one time –grounds for a default re-pricing with other banks – poses less risk than one who has fallen past due on a series of similar obligations with others. Of course, customers are the ultimate arbiters.

Therefore, we were disappointed that the Committee's questions focused mainly on off-us re-pricing. We disagree from both a customer service and safety and soundness perspective that only one method of risk-based re-pricing is best for all customers. That is why we have markets. Customers who fear they will default on other obligations but are confident they will never pay late may wish to go to our competitors; those who generally manage their credit well but occasionally forget to mail their payments may wish to come to Bank of America. And if either of us is wrong, the market will tell us that.

Of course, effective consumer choice depends upon full transparency and clarity of disclosures, so consumers make informed choices. The Federal Reserve is in the process of amending Reg Z to better facilitate such comparisons by consumers. And as I will describe later, we are working independently to improve customer understanding.

We strongly believe Congress should not eliminate consumer choice in this area, and decide for consumers which system is better. We fail to understand how that is a pro-consumer outcome.

Bank of America Puts its Customers First

Customer Experience Initiative. What we refer to as the "Customer Experience," is a top priority for Bank of America and Card Services. This priority includes careful consideration of the customer as we introduce new initiatives, continuous solicitation of customer input and responsive handling of customer complaints. Within the bank's Global Consumer organization, a team was established in the fourth quarter of 2006 to work exclusively on this issue, and four key pillars define the work of this group:

- Value - customers perceive good value for the price they pay for our products and services;

- Treatment – customers want to feel they are important to us;

- Operational Excellence – customers expect transactions to be processed accurately, efficiently and timely;

- Problem Management - customers define a problem any time we fail to deliver the expected experience for them.

This intense focus on the Customer Experience includes participation by executive leadership, and Customer Experience performance was included in all associate performance plans for full year 2007. I *personally* have spent hundreds of hours in the last year listening to our credit card customers, reading their complaint letters and have required my leadership team to do the same.

We operate our business to minimize and appropriately address customer complaints. Significant initiatives – including re-pricing decisions – include consideration of the customer impact – frequently through focus groups and pre-deployment testing. I have already described several specific practices that minimize the impact of re-pricings, including:

- our two-event trigger for default re-pricing;
- the discretion we regularly exercise NOT to re-price most customers who exceed these two triggers;
- our 12-month stand-off on the frequency of re-pricing; and
- allowing customers to “just say no” to behavioral re-pricings.

Our well-trained associates, equipped with information and tools necessary to understand our customer needs, interact with millions card customers each day. Through these interactions the vast majority of customers’ questions, concerns and problems are addressed, and we have systemic processes that capture and respond to what our customers are telling us.

We educate our customers about our products and services and offer them tools to better manage their accounts, because well informed customers make the best choices.

Bank of America has simplified the language in its customer materials to ensure it is straightforward, easier to understand and provides customers with information they need to better manage their accounts.

- "Credit Cards & You," for example, provides clear information about interest rates, grace periods, how cash advances and balance transfers are treated, how payments are allocated among outstanding balances, and the importance of paying on time and staying within your credit limit.

Following customer research, Bank of America also began offering services to assist customers in managing their accounts and avoiding unintended fees and interest charges.

- Online Banking allows customers to view their accounts and know where they stand with their latest checking, savings and credit card account activity. Customers can track activity, transfer funds and pay bills any time, anywhere they have a computer with Internet access.

- E-alerts are messages sent to customers' computers, PDAs or mobile phones that they can individually customize to better manage their accounts and also help protect against identity theft.

- Account Linking helps ensure that funds are automatically transferred from a customer's savings account, line of credit, or credit card to his/her checking if payments exceed the checking account balance.

To increase awareness of these resources, Bank of America launched an online advertising campaign. The ads, which carry the theme "A Little Knowledge Is a Powerful Thing," educate consumers about tools available to provide them with more information about their accounts. Now, a new online site, “Fees and Processes Explained,” provides easy-to-understand credit card and deposit fees and processes information. The site is available to the general public through www.bankofamerica.com and through various access points from Online Banking.

We remain committed to improving the customer experience. While substantial progress has been made – and we can show significant improvements in the way our customers feel about us – we remain focused on our goal of offering our credit card customers a better experience than any other bank. In our view, this competitive determination to do the right thing for consumers has provided, and will continue to provide, tangible and more dynamic benefits for consumers than static legislative solutions.

Customer Assistance. Despite our efforts to educate customers and give them the tools they need to manage their accounts, some customers experience serious financial problems – often outside of their control. We work hard to assist our customers who do experience such problems. Our associates are educated and empowered to take a holistic approach when dealing with a customer experiencing financial difficulties. If a customer can not afford to make regular minimum payments or falls behind on an account, our Customer Assistance group takes all of the customer’s monthly expenses and income information into consideration in seeking to find the best solution. In many instances we modify the terms of an existing account to address the customer’s current circumstance, which might include lowering the interest rate, reducing the monthly payments, eliminating interest and/or fees, or referring the customer to a debt management program. In fact, at any point in time approximately 17% of delinquent balances in the US credit card portfolio have reductions in minimum monthly payment and/or interest, in order to assist customers work through their financial difficulties.

In performing this function, we’re responsive to current market conditions. As an example, we are aware of current troubles in the mortgage market some consumers are experiencing. Today as we obtain debt-to-income information from the customer, our associates ask whether the customer's delinquency is caused by an adjustable rate mortgage reset, and in the near future, we are educating our associates to proactively inquire of each customer whether a future ARM reset may impact his or her ability to make regular payments.

As part of our efforts to encourage customers with financial troubles to contact the bank for assistance, we work closely with non-profit credit counseling organizations to provide the financial, budgeting and housing counseling that will assist consumers in resolving their financial distresses. Bank of America is one of the major leaders in providing financial support to non-profit credit counseling agencies that demonstrate sound business practices and provide quality financial education and counseling. The bank has provided millions of dollars in support to these groups in recent years.

Conclusion

Taking risk into account – based on both our own experience with each customer and on the experience of other creditors – makes good financial sense, helps us to manage risk on an individual basis for each customer, and makes credit readily available at more competitive prices. As GAO has found, this evolution within the industry has greatly benefited millions of consumers. Every credit card company uses different pricing strategies based on what they think best serves their customers and what makes them the most competitive in a highly competitive market place. We strongly believe ours is what provides the most credit at the least cost to more of our customers while fairly pricing for risk.

Thank you for the opportunity to share our views today. I look forward to any questions from the panel.