Statement of

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before the

Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

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Discover Financial Services[1] appreciates the opportunity to comment on H.R. 5244.

When Discover® Card was launched a little over 20 years ago, it was a unique credit card, introducing features that changed the marketplace. Unlike other cards then available, Discover charged no annual fee. Discover pioneered credit card reward programs with the groundbreaking Cashback Bonus® award that allows customers to receive up to 1% of their purchases back as a cash reward. (This feature today returns

1. Discover Financial Services is a leading credit card issuer and electronic payment services company with one of the most recognized brands in U.S. financial services. The company operates the Discover® Card, America's cash rewards pioneer, with more than 50 million Cardmembers, and is one of the largest card issuers in the U.S. Its Third-Party Payments business consists of the Discover Network, with millions of merchant and cash access locations, and PULSE, one of the nation's leading ATM/debit networks. Discover recently announced an agreement to acquire Diner's Club, International.

more than $700 million to Cardmembers annually - more than $7 billion since 1986). Discover also introduced a level of service that was unknown at the time in the industry: "24/7" toll-free service lines, staffed with knowledgeable representatives empowered to respond rapidly to Cardmembers' needs.

We still offer these features, and continue to build on them. For example, last year we introduced the Discover Motiva Card, which was recently named the "Best New Card Product" of 2007 by a leading industry publication. Motiva was another industry first, providing interest rebates to consumers who pay their bills on time. Cardmembers who make six consecutive on-time payments earn a Cashback Bonus award equal to the amount of the finance charges shown on their next monthly statement. This encourages payment behavior that avoids late fees and interest rate increases while also lowering the balance owed on the account.

We continue to work with our customers to understand what they value, and then strive to create products and services that meet their needs. There are some things we don't do:

- We don't target subprime borrowers or offer a Discover® Card to everyone who applies. We turn down more applicants than we approve.

- We don't outsource loan origination or loan servicing: every Discover® Card we issue is underwritten by us and serviced by Discover.

- We view the customer relationship as a long-term arrangement - and so do our Cardmembers. Less than 5% of Discover customers close their accounts each year, a very low attrition rate in the credit card industry. In fact, Discover has ranked number one in the industry for customer loyalty for 11 years in a row. [2]

- We don't outsource customer service: every service call is made or answered in-house by a Discover employee in one of our service facilities across the United States. Last year our Cardmember Services representatives spoke with Discover Cardmembers more than 30 million times. These interactions allow us to understand what's on our Cardmembers' minds and how they expect to be treated, and to adjust our products and services accordingly.

Discover helps our Cardmembers manage their accounts with user-friendly features (like free online and telephone payments and balance paydown calculators), clear disclosures and statements and understandable information. We reach out proactively to Cardmembers who appear to be having difficulties. Each month we contact tens of thousands customers whose accounts are not past due or over limit, but appear to show signs of financial stress, to offer assistance through customized account management programs.

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[2] Brand Keys Customer Loyalty Engagement Index, 1997-2008. Discover also was ranked "Best in Class" for customer loyalty in Gallup's 2006 and 2007 surveys.

This is working:

- The percentage of Discover Cardmembers whose payments are delinquent has declined by 40% over the past five years. Even in the current economic climate, payment defaults are near historic lows.

- Our Cardmembers' late fees and over limit fees have declined very substantially over the last five years.

- We allow Cardmembers to pick a payment date that is most convenient for them, and we do not move that date.

- We provide an additional day, after the stated payment due date, to ensure that payments we receive are promptly credited and late fees are not charged.

- A very small percentage of Discover Cardmembers pay interest rates at the maximum interest rate. Three out of four Discover accounts received a *reduction* in interest rates over the past year.

With millions of Cardmembers, it is not possible to please everyone, but we think we do a good job responding to Cardmembers' expectations. In last year's JDPower & Associates customer satisfaction survey, Discover was the only credit card that ranked first or second in every category studied. Survey respondents said that Discover had the lowest incidence of problems among the 10 largest issuers, ranked us highly for problem resolution, and second for "fees and rates."

Impact of H.R. 5244

We welcome this Subcommittee's focus on credit card practices, and support the goal of improving credit card services and practices. We appreciate the opportunity that we have been afforded to provide input to the Subcommittee in the development of this legislation, and are pleased that the bill as introduced included changes that reflect some of our comments.

As Subcommittee members appreciate, credit cards have become a vital tool for American consumers, many of whom use them to pay for needs until the next paycheck arrives, often without paying interest. Credit cards are being used for an ever-increasing number of services, and help consumers manage their household budgets and avoid extra expenses. For example, a growing number of consumers pay recurring bills, like utility bills and Internet service fees, via credit card to avoid mailing costs, service disruptions and late fees imposed by the service companies. The growing reliance on credit cards by consumers makes it all the more important that legislation changing the regulation of cards be carefully crafted to avoid unintended consequences such as reducing competition, increasing consumer costs or curtailing credit availability

A number of the requirements of H.R. 5244 are consistent with our current practices, or could be implemented without significant change. Still, we think some of the bill's key provisions are unnecessary or counterproductive. Most of the industry practices covered by the bill are being addressed by changes made by Discover and others in the marketplace. Other practices are the subject of current regulatory changes that are expected to be finalized later this year, after a thorough rulemaking proceeding that we are pleased is winding down. We believe that these developments should be permitted to unfold before statutory changes are made.

The Federal Reserve Board has proposed changing the Regulation Z requirements pertaining to changes in credit card interest rates, payment allocation practices, late and over limit fees and other practices that are the focus of H.R. 5244. For example, the Board has proposed a 45-day advance notice before account terms (such as interest rates) can be changed to give borrowers a chance to look for credit elsewhere if they want to avoid the new terms. The Board will soon propose new rules under its authority to address unfair and deceptive practices that we expect will include a nationwide requirement, similar to the one that currently pertains to Discover Bank under Delaware law, to allow consumers to opt out of "risk based" APR changes and pay off the outstanding balance at the "old" APR. Although the rulemaking process has been lengthy, both of these Federal Reserve rules are expected to become final later this year. Other regulators also are focusing on credit card industry practices, and the House of Representatives has approved a bill that would expand the authority of these bank regulators to address unfair and deceptive practices by issuing regulations.

The regulatory process allows changes to be made by those with years of experience regulating credit card lenders, and the ability to examine banks for compliance with the rules they write or enforce. Regulators also have the ability to examine the impact of proposed requirements on consumers before they are implemented through consumer focus groups, interviews and other techniques that allow proposals to be fine tuned to ensure they achieve their desired intent. In addition, requirements developed through the regulatory process can be adjusted over time through rule changes and the examination process to keep abreast of changes in industry practices, information technology and consumer needs.

In short, pending regulatory actions, as well as changes in the marketplace, make the enactment of H.R. 5244 unnecessary. More important, the bill would prohibit a number of longstanding practices that do far more good than harm. These practices encourage the responsible use of credit and reward responsible credit users with lower interest rates, larger credit lines, longer-term account agreements, rewards programs, and other benefits. They also provide borrowers who have less than perfect credit histories with access to credit that they would not otherwise find – from mainstream lenders.

Risk-Based Pricing

The principal impact of HR 5244 is its prohibition on risk-based changes in the interest rate on a credit card balance. This provision purports to address “universal default,” a term that formerly referred to the practice of changing interest rates on an account when the borrower "defaults" - misses payments or stops making payments altogether - on an account with another lender. We do not use a missed payment with another lender as the basis for increasing interest rates.

What the bill actually does is to prohibit interest rate changes on the basis of *any* information (not just payment defaults) that reflects deterioration in the creditworthiness of the borrower and the ability or willingness to repay debts. For example, it prohibits APR adjustments based on information about how a customer uses his or her account in combination with the borrower's FICO score, or other information (e.g., changes in outstanding borrowing, loss of income, or the filing of a wage garnishment) that make it less likely that the current loan balance will be repaid. This prohibition is based on a misunderstanding of how lenders actually utilize so-called "off us" information, and appears to disregard the negative consequences that would be felt by large numbers of borrowers and applicants if lenders are prohibited from making risk-based price changes.

Information about how an individual uses credit extended by others is a demonstrably reliable predictor of a borrower's likelihood of continuing to repay existing and future loans. Historic data on millions of borrowers has been incorporated into risk scores that predict the likelihood that an individual with a specific risk score will default on his or her loans in a specified number or months or years. The use of this information in underwriting and pricing consumer credit cards has brought about the "democratization of credit" that has lowered interest rates for more creditworthy borrowers and allowed lenders to extend credit to greater numbers of individuals. As former Federal Reserve Chairman Alan Greenspan observed:

> "Experience indicates that access to the information assembled by [credit reporting agencies] and credit evaluation systems based on that information have improved the overall quality and reduced the cost of credit decisions while expanding the availability of credit." [3]

Risk-based pricing is one of the developments that has allowed the credit card to evolve from a product offered to affluent borrowers likely to have assets and other resources to pay their bills into a widely available (and popular) borrowing tool that is based on assessments of a borrower's ability and willingness to repay loans out of future income.[4] In addition, the models used to identify risk have improved with use over the past two decades, and changes have been made in the data that is used in these models. For example, the Fair and Accurate Credit Transactions Act (2003) amended the Fair Credit

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[3] Letter of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, to the Hon. Michael N. Castle (July 22, 2003).

[4] An ancillary benefit of credit risk-scoring models is that they ensure that credit decisions are based on objective information about an individual's use of credit. These systems, required under the by the Equal Credit Opportunity Act to be "empirically based and statistically sound" replaced so-called "judgmental" systems that predicted default risk based on individual analysts' reviews of information about borrowers and analyst "expertise" in spotting characteristics thought to relate to risk. Judgmental systems were criticized by regulators and lawmakers as subjective, and prone to individual evaluator bias. They were also imprecise: sometimes signs of risk were missed and credit was extended to unqualified borrowers or on unsound terms, while in other cases credit was denied to creditworthy individuals based on unwarranted concerns. As a result of this imprecision, higher across-the-board credit standards, higher interest rates, one-size fits-all APRs, and fees were used to ensure that default risk was spread across the portfolio The risk scoring models we use today are based solely on objective information relevant to an individual's use of credit, and they address both the lack of precision and concerns about objectivity and fairness inherent in judgmental systems.

Reporting Act to enhance the accuracy and completeness of consumer report data through new obligations for both credit bureaus and creditors that furnish information to them.

Although H.R. 5244 prohibits pricing adjustments based on changes in risk, it nevertheless recognizes that information about a borrower's use of credit extended by other lenders is pertinent to credit-granting decisions. The bill allows this information to continue to be used at the time of application in deciding whether to extend credit, the interest rate that will be charged, the amount of credit to be extended and the length of time for which credit will be offered. It allows this information to be used after an account is opened to take actions (other than changing the interest rate) to respond to changes in default risk, such as lowering credit lines or closing accounts. *And the bill recognizes that external information can be used both before and after an account is opened to adjust the interest rates on the outstanding account balance: it permits variable interest rates that change based on movements in the prime rate set by the Federal Reserve.*

There is a misconception that a large percentage of U.S. credit card users are subjected to risk-based interest rate increases. In fact, at Discover, changes in a risk score do not automatically trigger a price change or evaluation, and only a small percentage of accountholders are affected by risk-based interest rate changes. Credit scores for some borrowers change frequently, even monthly, but these changes are not the basis for interest rate adjustments. Risk-based price changes are made periodically, on a targeted basis, and most accounts are not affected. For example, new accounts (those opened less than a year) are not eligible for repricing. Thereafter, the APR on an account will not be considered for a risk-based adjustment more than once a year. Other exclusions include accounts subject to repayment agreements.

The last thing that any lender wants to do is to increase the chance that the borrower will default on a loan because it carries a higher interest rate. There is nothing to be gained by adding additional interest to an account balance if that interest, along with the principal balance, will end up being written off because the loan became unaffordable and payments ceased. Experience shows that risk-based interest rate changes motivate consumers to improve their payment behavior by making larger payments and reducing purchase activity. Some accountholders take advantage of their option to close their account and repay the balance at the old APR, but most choose to keep their accounts open and available for use even with a higher interest rate.

Risk-based pricing of credit cards is like risk-based price increases for auto insurance premiums. Drivers who run up accident claims on other policies, move to high accident locales, or collect tickets for driving violations are charged higher premiums, even if they pay their insurance premiums on time. These increases allow safe drivers to pay less. Legislators have not stepped in to reward these high-risk drivers and protect them from the consequences of their risky behavior by outlawing premium increases that are based on external information predictive of increased insurance claims.

Missing loan payments or running up high balances with other lenders are consumer behaviors that Congress should encourage consumers to *avoid*. Customers who default on loan payments with other lenders, or increase their total indebtedness without a corresponding increase in income, are demonstrably riskier borrowers whose financial management has worsened. Their likelihood of defaulting *on outstanding debts* has increased in a predictable and demonstrable way. Prohibiting lenders from making APR changes when this occurs will inevitably result in higher lender costs and negative consequences for other, more responsible, consumers. The ability to price for risk allows the higher costs of lending to riskier borrowers to be borne by the individuals who cause them. Prohibiting lenders from recovering these costs from those responsible for them will result in higher costs for lenders and their lower-risk borrowers.

A ban on risk-based APR changes will require lenders to use other risk-management techniques when customers show signs of risk, like restricting credit limits and possibly closing accounts to future purchases. However, when credit limits are frozen or reduced, or accounts closed, borrowers experience more than an inconvenience and the need to look elsewhere for credit. Moreover, an account closing is an adverse action that negatively impacts the consumer's credit score. Reducing credit limits has the same effect: the individual's "credit utilization" goes up because the customer's outstanding loan balances now account for a greater percentage of their available credit. Higher credit utilization, in turn, results in lower FICO scores, negatively impacting the individual's ability to obtain credit from other lenders. Thus, a restriction intended to protect consumers from risk-based price changes may result in other risk management responses that might be worse than paying a higher rate of interest, and reduce access to credit for the very borrowers who may need it the most. Some borrowers may prefer to have an open line of credit that costs more to use than a credit line that has been reduced, frozen or closed. H.R. 5244 eliminates this choice.

Default-Based Interest Rate Changes

While H.R. 5244 recognizes the legitimacy of changing the APR on a credit card balance when a borrower defaults on contractual obligations, it imposes significant delays on implementing these changes, and an option to avoid the APR increase altogether,   APRs on borrowers who default cannot be changed unless a 45 day billing statement notice of the change and the right to avoid it is provided first – a requirement that may require the pre-default rate to remain in effect for two full billing cycles. In addition, interest collected at the default APR during the following three billing periods would have to be rebated if the consumer elected to opt out of the increase.

These requirements delay the implementation of the contractual penalty for customers' default behavior that was established in advance as part of the borrower's credit card account agreement. This delay rewards consumers who have failed to meet their loan obligations (and represent an increased default risk). The Federal Reserve's proposals provide a more sensible approach, by permitting consumers to opt out of default-based interest rate changes without prolonging their ability to avoid APR increases if they decide not to opt out. Discover intends to offer this option to our Cardmembers.

It is important to remember that the best way to help consumers to avoid interest rate increases for missing payments is to encourage and facilitate on-time payments. Discover has made making on-time payments increasingly simple. The result, as noted previously, has been a very significant decline in the percentage of customers who pay late.

In the first place, we provide Discover Cardmembers ample time from the mailing of statements until the payment due date to assist customers who send payments by mail in getting payments to us on time. Cardmembers can select a statement date so that their Discover statements arrive at a time most suitable for them. We work with the U.S. Postal Service to expedite the delivery of statements. Outgoing mail is presorted by us and delivered by us to postal facilities. In many cases this avoids the need for handling by postal Service facilities and by employees other than the letter carrier who brings the mail to the consumer's home. Incoming statements are picked up by Discover from the Postal Service facilities and processed promptly so that payments are posted as of the day we receive them.

Discover also provides a number of no-cost alternatives to sending payments by mail. Free on-line payments, that Discover regards as timely if received by 3:00 pm on the date payment is due, enable Cardmembers to make payments on time, without charge. This avoids late fees, default-based APR increases, and postage costs. A growing percentage of our customers make their payments online either at Discover's Website or through sites operated by the other financial institutions. Cardmembers also can schedule automatic payments in any amount (from the minimum due to the full balance owed) to be debited from checking or other accounts and credited by the payment date. This free service allows customers to avoid fees and penalties even if they forget the payment date or misplace the account statement. Furthermore, Cardmembers can also make payments over the telephone without charge, even on the due date.

We should mention that the Federal Reserve Board is in the process of implementing a statutory requirement designed to make sure that credit card billing statements prominently disclose the amount of late fees and the date by which the payment must be received to avoid late fees. If there are consumers anywhere who cannot find this information, this new "front of the statement" disclosure will make it easier for them to do so.

In addition to assisting Cardmembers in avoiding late fees, Discover minimizes the long-term impact of default-based price increases by reducing interest rates if the customer resumes on-time payments after a default. Interest rates are automatically lowered if the Cardmember makes nine consecutive on time payments.

"Two-Cycle Billing"

H.R. 5244 purports to ban “double cycle billing” (a method of computing the interest rate on a credit card balance that Regulation Z calls the “two-cycle average daily balance computation.) In fact, the language is broader: the text of this provision actually restricts <u>all</u> balance computation methods, requiring credit card lenders to provide interest free loans on any portion of a credit card balance that is repaid during the billing cycle. This would fundamentally change longstanding industry practice and the rationale for grace periods. Grace periods – which constitute interest free loans - have long been offered as an incentive to consumers who pay the full account balance during the grace period. The proposed change would, instead, provide this benefit to customers who do *not* repay the full balance, but make partial payments and “revolve” the rest of the loan balance. A legislative mandate that establishes the terms for offering grace periods, prohibits the assessment of interest on borrowed funds, and rewards consumers who elect to pay less than the full balance owed is not warranted. We believe this provision should be dropped.

Even if the bill were limited to address only the “two-cycle average daily balance computation method,” a prohibition on that practice would be unnecessary. As explained in more detail below, the two-cycle computation affects a relatively small number of credit card users who usually pay their account balance in full. When they do not, the computation imposes what in most cases is a low-dollar increase. This is often a one-time occurrence.

The two-cycle computation is a legitimate practice, expressly recognized in Regulation Z, and used for more than 20 years. Bank regulators are familiar with it and examine banks that use it. They have not questioned this computation method as improper under The Truth in Lending Act, unfair and deceptive practices laws, or otherwise. In examining the required disclosure of the two-cycle and other computation methods in its current rulemaking, the Federal Reserve found that consumers do not necessarily consider balance calculation methods when considering or comparing credit cards.

The two cycle computation does not have a significant impact on consumers. It applies only in limited circumstances that affect "convenience users" who are able to pay the full balance on their credit card accounts each month, collecting credit card "rewards" without paying interest. The two-cycle computation affects these individuals only when they begin a billing cycle with a zero balance, make purchases, but elect to pay less than the full balance. This additional interest paid by this small subset of borrowers is usually small, and is not paid repeatedly.

In commenting on previous legislation that would have required all credit card issuers to use the average daily balance computation so consumers more easily compare different credit card offers, the Federal Reserve cautioned against the proposal:

> *"[R]egulating the balance computation area might result in restricted credit availability, the elimination of grace periods, or higher interest rates, annual fees or merchant discounts. It is uncertain, therefore, whether the benefit of having a uniform balance computation method would exceed the associated costs to consumers after such adjustments have taken place."*[5]

[5] Statement of Emmett J. Rice, Member, Board of Governors of the Federal Reserve System, to Senate Banking Committee, Financial Institutions Subcommittee, May 21, 1986, p.53).

A statutory prohibition of the two cycle computation method is not necessary given its limited impact on consumers, regulators' existing authority to ensure that it is not harming consumers, and changes in the marketplace. With regard to changes in card issuer practices, we should note that while for many years the two cycle computation has been used across the industry, this is changing. In 2006, as part of our ongoing competitive review of industry-wide practices and our own product features, Discover decided that all new card products (such as our Discover Miles Card and the Discover Motiva Card) would use the average daily balance computation method rather than the two-cycle method. At the same time, we made a decision that in the future other new Discover accounts will use the average daily balance computation. Discover Cardmembers now have the ability to choose a Discover card that does not use this computation method.

Over limit Transactions

HR 5422 requires cards that charge over limit fees to allow consumers to block all transactions that would exceed the credit limit.

While some banks may charge an over limit fee whenever a credit card transaction brings the balance above the account's spending limit, Discover does not. We make the over limit computation once - on the last day of the billing cycle - and impose an over limit fee only if charges posted to the account during the month exceed the authorized spending limit <u>*after*</u> *payments and credits are posted*. Thus, while a purchase, utility bill payment or other transaction might exceed the credit limit, this will not result in an over limit fee if transactions are offset by payments sent to us or through credits from a merchant (e.g. for returning merchandise or checking out of a hotel with a bill lower than the preauthorized "hold" on the account). H.R. 5244 would require all card issuers to use this method.

Discover also provides Cardmembers with tools to help avoid over limit transactions in the first place, like online reminders that alert customers when they approach their credit limit. Proactive outreach to customers who appear having difficulties keeping below their credit limits is another tool we use to help Cardmembers stay within their spending budgets and avoid repeat over limit fees. These measures account for a significant decline in the incidence of over limit fees on Discover accounts.

We do not believe that most consumers would elect to have a credit limit that cannot be exceeded for any reason.[6] However, we intend to offer Discover Cardmembers the ability to block transactions that exceed their credit limit with designated exceptions. Other issuers are offering comparable options. We think that this is another example of an issue that is being addressed in the marketplace, offering consumers a choice that does not require a statutory mandate and regulations to implement it.

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[6] A customer near his or her credit limit who has just mailed a check bringing the account balance to zero does not want to be embarrassed or inconvenienced when a transaction is blocked because the incoming payment was not yet posted. Customers are not likely to appreciate the annoyance or extra costs that would result if preauthorized payments for services like utility bills, highway toll passes, and Internet access are blocked, and penalty fees are incurred. Card users might experience more serious consequences if payments for emergency services like late night tow trucks, or gasoline to fill empty tanks, are blocked.

Changes to Account Terms

Credit card account agreements are sometimes criticized as unduly lengthy and confusing, yet H.R. 5422 includes a requirement that is likely to contribute to the so-called complexity. The bill prohibits changing account terms during the life of the account, unless the "specific material reasons" for a change is set forth in the agreement at the time the account is opened. It applies to changes that reduce consumer costs as well as those that might increase them, and even to changes made in response to statutory or regulatory requirements.

This will make lengthy credit card agreements longer still, as card issuers try to anticipate and enumerate every potential change, and the reasons for them, so that account agreements can be amended in response to economic conditions, customer needs, competition or legislative or regulatory mandates.

There is no reason to believe that consumers need, or will read, lists of changes that might be made to their account in the future. The current Delaware requirement that consumers be given advance notice and the right to opt out of changes in terms is preferable. This provides information about actual, as opposed to possible, changes and gives it to the customer when the customer is most likely to need that information. The Federal Reserve has proposed that this requirement apply to all terms changes and mandates a 45-day advance notice.

Payment Allocation

This bill requires a pro rata allocation of payments on accounts with multiple balances at different APRs. By prolonging the time period during which zero or low-APR loan balances will be repaid, this changes the economics of offering low-APR introductory or balance transfer offers. It will result in the elimination or reduced availability of balance transfer offers, depriving consumers of their benefits. The Federal Reserve's proposed rule on this issue – prominent disclosure when promotional offers are made about how payment will be allocated – is a preferable approach that informs consumers about potential costs without depriving them of low-APR credit offers.

Conclusion

H.R. 5244 addresses a wide variety of issues that are already the subject of regulatory rules that are being readied for final implementation, and scrutiny by regulators through the examination process. Other practices that the bill would regulate are being addressed in the marketplace as competitors change their product offerings and policies to win customers from other card issuers. We would urge the Subcommittee to allow these developments to play out before enacting statutory mandates that are difficult to change and may have unanticipated consequences. Should the Subcommittee elect to proceed with statutory changes, we will continue to assist the committee in understanding the impact of its proposals on credit card users, and work to refine the bill to achieve its consumer protection objectives.