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Hearing on the Credit Cardholders' Bill of Rights, H.R. 5244

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Introduction

Good morning, Chairwoman Maloney, Ranking Member Biggert and Members of the Subcommittee. My name is Gregory Baer and I am a Deputy General Counsel at Bank of America focusing on Regulatory and Public Policy. I appreciate the opportunity to discuss our views on the Credit Cardholders' Bill of Rights Act of 2008, H.R. 5244.

This is Bank of America's second appearance before the subcommittee on these issues, and we had the opportunity to participate in your credit card summit as well. We are pleased that the subcommittee intends multiple hearings on the legislation and will hear from regulators, various issuers and other experts. While we understand most of the major issuers will at some point testify, we also encourage the subcommittee to hear from smaller issuers that target specific economic segments of the population that could be more vulnerable during these current economic conditions. The issues being discussed today are of great importance to our economy, and the risk of unintended consequences, both to consumers and to the overall economy, is significant.

Bank of America provides a full range of financial services to individual consumers, small- and middle-market businesses, large corporations and government entities. In the retail space, Bank of America Card Services has more than 40 million active customers and more than $200 billion in managed loans. At Bank of America, we believe that we have this volume of customers because we listen to them – more than 90 million calls per year – and work hard to meet their needs, minimize mistakes and continuously improve.

Today, I will focus my comments on how H.R. 5244 would affect our ability to serve consumers. First, I will discuss the current competitive and regulatory environment for credit cards. Then, I will highlight the likely impact of particular provisions of the bill.

In sum, we believe that H.R. 5244 would significantly hinder the ability of financial institutions to price the risks of credit card lending, and would result in less credit being made available to creditworthy borrowers, with generally higher prices for those who do receive credit. Because we see the card industry as a highly competitive one, we do not believe that legislation setting terms and, implicitly, prices is necessary to protect consumers, who generally benefit from competitive financial markets. H.R 5244 is also likely to have other unintended effects.

Overview of the Industry

A credit card relationship offers consumers unique flexibility and choice. Every time a consumer uses a credit card, for any reason, the customer is receiving an unsecured loan that the lender grants based largely on the customer's earlier promise to repay. If the customer wishes to charge additional items or is unable to repay the loan immediately, the lender has agreed in advance to allow the customer to revolve a balance on the loan up to a pre-determined amount and repay a portion each month, thereby avoiding the need to apply for a new loan. The amount revolved and the length of repayment is

largely up to the consumer. But this flexibility for the customer means real challenges for issuers who must earn a reasonable risk-based return and operate safely and soundly. Before risk-based pricing, card companies simply charged all cardholders a relatively higher rate at the outset, and declined credit to those who presented more risk.

Risk-based pricing has revolutionized the credit card industry. Issuers have developed sophisticated modeling capabilities that combine internal data with credit bureau information to predict future performance and price loans accordingly. Such innovations, coupled with the law that this Committee crafted (the FACT Act) to help make sure credit history information is more reliable, have helped lenders manage risk better than in the past. The result has been democratized access to credit – allowing lenders to offer affordable, mainstream credit to consumers who previously might have been denied from receiving bank loans or other traditional forms of credit. The GAO recently documented these benefits as part of an exhaustive study, which also noted that this transition, combined with vigorous competition among issuers, lowered rates for vast segments of credit card users.

Risk-based pricing is first employed when we receive an application from a consumer. We pull a credit bureau report, and consider the consumer's FICO score and general credit history. That information is useful, but as the years go by, and the customer's financial situation changes, sometimes significantly, the original score tells us less and less about the risks we are actually running when we lend to the customer each month. But our actual experience with the customer, and information about the customer's ongoing behavior with other lenders, tells us quite a lot. We can thereby offer lower rates to customers who manage their credit well and relatively higher rates to those who don't. We take experience into account in two ways:

Default re-pricing

Default pricing (sometimes called penalty pricing) occurs when a customer is late or overlimit on an account, and the APR is increased as a result of that default event. Default pricing is disclosed upfront as a part of the Schumer Box and is set out in the credit card agreement. The change, therefore, is made in the context of the existing agreement. Our practice at Bank of America is that a customer must be late or overlimit not once but twice within a 12-month period on his or her Bank of America credit card account before default pricing can be applied. (Some issuers treat a bounced payment check as an event of default, but Bank of America does not.) However, not all customers who hit our default triggers are necessarily re-priced and, of those who are re-priced, not all go to the full default rate. We look at these customers individually, and determine whether the default truly indicates heightened risk.

Risk-based re-pricing

When we see that a customer is exhibiting risky behavior — and this may include high utilization (maxing out credit cards) or delinquency with other lenders — we may seek to charge the customer a higher interest rate. But the customer always has notice and

choice. If the customer does not wish to pay the higher rate, he or she can simply decline the proposed change in terms and repay the existing balance under the old interest rate; the only thing the customer need do in return is stop making additional charges on the card. (The customer's right to say no is the crucial distinction between risk-based pricing and universal default, in which Bank of America has never engaged.)

I should note that our experience shows that nothing frustrates customers more than an increase in their interest rate. At Bank of America, where our goal is to make a credit card customer a mortgage, deposit, brokerage and retirement savings customer, we have all the more reason to maintain competitive prices and keep customers satisfied. Looking at our 2007 portfolio, the overwhelming majority of customers – nearly 94% – had the same or lower rate at the end of the year than they did at the beginning, and four times as many customers had a lower rate than a higher one.

So, why would we ever raise rates? First, because for these customers, we are confident that we bear real, increased risk. Repeated, rigorous testing shows that our internal models, supplemented by FICO scores, are extraordinarily predictive of consumer behavior. GAO and other studies have confirmed as much.

Furthermore, when we re-price customers, we find that the repricing itself does not cause any significant increase in default – in other words, for two groups of borrowers with a given risk profile or score, those who accept a change in terms to a higher, risk-based rate do not default more than a control group who are kept at a lower rate. But both groups default 50% more frequently than our average customers – confirming that our models are truly predictive of eventual customer default. Many repriced customers tend to manage their credit more wisely, making larger monthly payments and paying down their debt faster. Thus, from our perspective, a higher interest rate not only allows us to earn income to compensate for greater risk, it actually reduces the risk we are managing and causes the customer to manage credit more wisely.

Some of the borrowers to whom we propose a change in terms exercise their right to opt out of a higher rate – an option Bank of America offers for any risk-based re-pricing. And of course there are others who do not opt out but simply transfer their balance to another issuer. This is the market at work. Either we have over-priced the risk of this borrower, and are losing a valuable customer, or our competitor has under-priced the risk of this borrower, and is taking on undue risk.

In some cases, borrowers do have problems paying the higher rate, because they are in genuine financial distress. If a customer falls behind on an account, our experience tells us it is likely due to circumstances outside his or her control. In our Customer Assistance division, we believe each account should be reviewed on an individual basis by using "account recognition" skills. Account recognition means taking all the customer's information into consideration before determining the best way to resolve the situation. If assessment of a customer's financial situation determines that he or she is unable to maintain the minimum monthly payments, we will offer several options to assist with the

repayment of the loan. The right program is determined by understanding whether the customer is experiencing short- or long-term financial difficulties.

In addition, on an annual basis, we award approximately $6 million to non-profit credit-counseling agencies that help people work their way out of financial distress. We work hand-in-hand with these agencies to tailor customized loan arrangements to fit individual circumstances and to help people get back on a solid financial footing.

Second, charging higher rates to our riskiest customers allows us to hold down interest rates and fees on our less risky customers – those who manage their accounts responsibly. Thus, a large segment of our accounts – those who pay off their balance each month – pay no interest or fees for the benefits of their cards. These so-called "transactors" pay their balances in full each month and receive the benefit of a grace period, whereby they receive an interest-free loan provided that they repay in full each month, thereby demonstrating themselves to be very low risk customers. The emergence of this option demonstrates the level of competition in the market place. Risk-based pricing allows us to reward less risky consumers by charging them relatively less.

And of course the market here is dynamic. If a significant number of consumers demonstrate that they are intolerant of the possibility of rate increases, someone will innovate to meet that need, and profit from it. Such innovation is going on right now. But H.R. 5244 would inhibit innovation by setting in legislation important terms around which issuers now innovate.

Regulation Z and Unfair and Deceptive Practices Regulations

Of course, innovation in the market place depends in large part on customers understanding the differences among issuers, making informed choices about the products they select and how they use them. With the increase in flexibility and eligibility, the job of describing how the product works has become more complex. To address these concerns, the Federal Reserve Board has proposed substantial revisions to Regulation Z, which implements the Truth in Lending Act. We believe that the proposed revision is thorough and well crafted. The quality of the proposal reflects the fact that the Board conducted numerous focus groups with consumers in order to determine their preferences and needs. This work has resulted in the Board's proposal being shaped by those who will directly benefit from it. As a result, the regulation will provide customers meaningful disclosures in an even clearer format, and it will facilitate comparison shopping and better assist consumers in modifying their behavior, potentially reducing their costs.

More recently, Chairman Bernanke announced that the Federal Reserve also will promulgate additional consumer protections addressing specific credit card practices. We would encourage Congress to allow that process to move forward before enacting legislation. We believe the Fed's rulemaking provides a dynamic approach in such a rapidly evolving industry.

Effects of Legislation

Now let me turn to H.R. 5244, and express some of the more significant concerns that Bank of America has about the bill.

Risk-based pricing

As we read Section 1 of the bill, it would make four fundamental changes to our ability to price and manage risk.

First, it would prohibit risk-based re-pricing of existing debt at any time, even with notice and choice. For purposes of evaluating the impact of this provision, it is important to note that in the great majority of cases, we learn about an increase in a customer's risk *after* the customer has run up a large balance and utilized a large part of a credit line, not before. Thus, ***the risk lies in that existing balance, not future charges*** (which may not even be permitted if the customer has reached or exceeded the card's credit limit).

Thus, under H.R. 5244 once a customer ran up a balance of, for example, $9,000, then the interest rate applicable at the time of the charges – say, 9.9% – would continue to apply until the loan is repaid. Currently, we propose a higher interest rate to customers but tell them that they have the right to say no – to opt out of the increase and repay the existing balance under the old rate, so long as they stop using the card – but H.R. 5244 would say that they can keep the old rate *and* continue using the card at the new rate by accepting the proposed "change in terms" with no consequence.

As already noted, we have found that an increased interest rate causes borrowers to repay their outstanding balances in larger amounts and more quickly, thereby reducing our risk and their exposure. Under H.R. 5244, this tool would be taken away and the result would be higher prices and less credit available at the outset and throughout the relationship.

Second, in addition to letting them opt out of risk-based re-pricing, H.R. 5244 would provide customers the ability to opt out of default re-pricing – that is, allow customers to breach their agreement but suffer no consequence for it. Under H.R. 5244, a consumer could keep the loan open, making only a minimum payment; so, if interest rates rose, and the customer's credit rating fell and prevented him from obtaining other credit, the customer could repay as slowly as possible.

H.R. 5244 thereby would take significant steps to reduce a customer's incentive to manage credit wisely – to both the issuers detriment and the customers. A customer who consistently paid late or overspent would be given the opportunity to opt out of the higher rate that the customer agreed to pay in the event of such misbehavior. This customer's risk would be subsidized by those other customers who do not default on their contracts.

Third, as we read the bill, issuers would generally be prohibited from re-pricing except at the expiration of the term of the card. At that point, they could re-price by amendment for any reason – *except risk*.

Last, the notice mechanics of H.R. 5244 would seriously impede the ability of banks to respond to risk when that risk is identified. In aggregate, provisions of H.R. 5244 would give customers an extraordinary 135 days to decide whether to accept a higher interest rate or take their business elsewhere. This extended period and a lack of incentive for customers to pay in a timely fashion would significantly increase risk.

In sum, Section 1 of H.R. 5244 would increase issuers' risk and take away important tools they use to manage it. The results are not hard to predict. H.R. 5244 would at least in the short term reduce the cost of credit for existing consumers with damaged or deteriorating credit. However, it would reduce the ability of such consumers to obtain credit in the future. Knowing that any charges incurred by a consumer will continue to carry the same interest rate indefinitely, lenders – as a matter of both profitability and safety and soundness – would be required to restrict availability and raise rates for such borrowers. Finally, and most importantly, because it is difficult to predict at the outset which borrowers will end up defaulting, rates and fees are highly likely to rise for all borrowers.

Of course, one could respond that fewer Americans having credit cards, or being able to borrow less, is just what the doctor ordered, and that government-sponsored reductions in the amounts that consumers can borrow is appropriate. But of course this bill focuses only on credit cards. There is no reason to believe that consumers denied credit through credit cards will not choose to turn to payday lenders or other higher-cost, lower transparency sources of credit. And H.R. 5244 would also raise prices on the great majority of customers who are managing their credit responsibly, and currently benefiting from risk-based pricing.

Recent experience suggests that this course is not a wise one. There is general consensus that the major cause of the mortgage crisis was an originate-to-distribute model where players in the system had incentives to externalize or not fully consider risk. A clear lesson of the past year has been that both lenders *and consumers* suffer when lenders do not sufficiently consider risk in pricing loans.

As a credit card lender, we internalize risk. Credit card lending is unsecured, and if a customer defaults, we suffer the loss. The customer emerges with damaged credit, but loses no assets. H.R. 5244 would exacerbate this problem by limiting our ability to adjust terms to meet risk.

There is another area where a comparison of mortgage and credit card legislation is worthwhile. The major credit card companies fund more than 50% of their portfolios through securitization – currently more than $400 billion of receivables are funded through asset-backed securities. Investors in card receivables have taken comfort from the underwriting discipline of issuers, including their ability to adjust on a real-time basis for changes in risk. Obviously, the availability of funds would shrink or rise in cost to the extent that issuers' ability to price for risk was degraded, with this cost passed along to borrowers.

In considering legislation on mortgage lending, the Committee wisely continues to consult with a wide range of secondary market participants to determine the potential impact on already damaged credit markets. We believe this bill has the potential to have similar significant impacts on such markets, and would urge at least as much consultation before so profoundly changing the way credit cards are priced and managed.

Pro-rata Payment Allocation

As card lending has developed, customers frequently carry balances on which they carry higher interest rates. Cash advances, for example, carry higher rates than purchases; initial, promotional rates offered to encourage balance transfers often carry a lower, even 0% rate. Section 3(f) of the bill requires that any payment made by a customer be assigned pro rata to each balance; so a $100 payment by a customer with a $500 cash advance balance at 19.9 percent, $300 purchase balance at 9.9%, and $200 promotional rate balance at 0%, will be assigned $50, $30, and $20 respectively. Currently, most issuers would apply the $100 payment solely to the promotional rate balance.

Such an allocation scheme seems rational; however, the market should be left to produce such a structure, rather than having Congress mandate it by legislation. A clear downside of such an allocation system – and perhaps why the market has *not* produced it – is that it would severely curtail the use of promotional rates that have proven popular with, and valuable to, customers. Under the Fed's proposed Regulation Z, disclosure of payment allocation practices will be improved, and competitors will have an incentive to move towards pro rata allocation if there is genuine demand for it (and a corresponding lack of demand for promotional rates). It is worth noting that a customer who intends to pay off a balance after a couple of months would more rationally choose the former, but would be denied that choice by H.R. 5244.

Average Daily Balance

At its most elemental, lending means extending funds to a borrower in exchange for the payment of interest. Interest is assessed against the amount owed for the amount that the loan is outstanding, at an agreed-upon rate. Thus, if credit card lending were like all other types of lending, a cardholder would begin to pay interest at the time credit was extended – for example, at the time a purchase was made – and would pay interest for the use of those funds until repaid. In competing for borrowers, however, credit card issuers combined the benefits of a charge card – where customers were required to pay in full each month – with the ability to revolve a balance each month to create a unique exception to this rule: basically, that a loan would be interest-free in the event that the borrower repaid it in full at the end of the billing cycle. So, even if a customer borrowed money on the first day of the month and repaid it on the last – 30 days worth of borrowing, and 30 days of credit risk for the lender – no interest would be charged.

There was nothing foreordained about this outcome. It is not required by law; indeed, it is hard to imagine a law requiring banks to lend money interest free. It is certainly not

the market norm: one does not receive a refund of each month's mortgage interest if the principal payment is repaid; borrowers are not rebated interest they pay on a car loan if they repay the principal. Indeed, this outcome is rather extraordinary – and represents a major financial sacrifice by lenders, who could earn substantially more interest income under traditional practice. That, of course, is why its benefits have been limited to one type of borrower: the borrower who consistently repays in full each month, and thus represents the lowest risk.

For borrowers who do revolve a balance, issuers charge interest against the average daily balance over the cycle. Borrowers who revolve a balance – that is, do not repay in full – pay an interest rate that is multiplied by the average amount they borrowed during the month. That method is universal, relatively simple to understand, and, we thought, uncontroversial.

Under the average daily balance method, interest is owed on the average amount borrowed over the course of the previous period. Suppose, for example, that a customer with a 10% interest rate begins the January period with a carryover $1,000 outstanding balance, makes a $500 purchase halfway through the month and then pays $500 at the very end of the cycle. The 10% interest rate would be applied to the $1,000 for the first half of the month, and to $1,500 for the second half.

As we read the bill, Section 3 invalidates the average daily balance method of calculating interest owed on an account. Section 3 would, in effect, allocate the payment to the new purchases and dictate that the customer pay interest on only $1,000 for every day of the month - in other words, that $500 of the $1,500 in credit offered for the month be an interest-free loan. The section is self-described as prohibiting double-cycle billing, but would not prohibit double-cycle billing but rather single-cycle billing. (Double cycle billing - a practice in which Bank of America has never engaged - occurs when a customer who has been paying in full each month decides to begin revolving a balance; in a month where the customer began owing nothing, the interest rate is assessed against charges made in that month as well as the following month – that is, assessed in two cycles.)

As noted earlier, we currently make interest-free loans to our customers who pay off each month; H.R. 5244 would also require us to make interest-free loans to customers who revolve a balance, if they choose to pay off at the end of the month.

<u>Credit Cycle</u>

H.R. 5244 would mandate that there must be at least 25 days between the date the statement is mailed and the payment due date (as opposed to 14 days, under current law). Given that it takes us 3-6 days to generate and mail statements after the closing date (and given that months have 28-31 days), we would simply be unable to comply with this provision, absent the elimination of grace periods. Furthermore, in effect, this section would mandate that any grace period provided by an issuer – that is, any interest free loan – last a minimum of 25 days plus processing time – as opposed to 14 days plus

processing time currently. By mandating the length of a grace period, this provision would either further endanger the continuance of grace periods or cause other prices or fees to rise. Given the absence of any empirical evidence that customers need a time for mailing of greater than 14 days, we cannot support the government setting this term of the agreement.

Fraud Risk

Section 3(d) would prohibit issuers from reporting to a credit bureau the fact that a consumer has recently opened new credit card accounts until the card is used or activated by the consumer. This seemingly innocuous provision will significantly increase so-called "bust-out risk" – that is, what happens when an identity thief, or a customer facing a financial crisis, applies for multiple cards at the same time, with the goal of maxing them all out immediately. If our lenders see such behavior going on, they will not issue a card. But under H.R. 3244, they will be blinded to this risk until it is too late.

We have other, more technical, concerns about the bill, which we would be pleased to discuss with Committee staff.

Conclusion

Based on our own experience with each customer and on the experience of other creditors, it is imperative that we take risk into account when making lending decisions. Doing so makes good financial sense, and makes credit readily available at more competitive prices to more customers. Every credit card company uses different pricing strategies based on what it thinks best serves its customers and what makes it 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.