Statement of
Roger C. Hochschild
President and Chief Operating Officer
of
Discover Financial Services
Before the
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate
December 4, 2007

Mr. Chairman and Members of the Subcommittee, on behalf of Discover Financial Services,[1] I appreciate the opportunity to appear before you today to discuss the pricing of credit cards, and how credit card prices are adjusted.[2] The recent failures in the subprime mortgage area, attributable in no small part to lapses in credit underwriting and risk management, make today's inquiry to credit card lenders' pricing and risk management strategies particularly timely.

Interest rates are important to consumers, particularly those who carry a balance. But credit card users care about more than just a credit card's interest rate. Since Discover® Card was launched a little over 20 years ago, we have always offered both an attractive interest rate *and* a better product. We entered the market with a unique card: it charged no annual fee, and offered the groundbreaking Cashback Bonus® award that allows customers to receive up to 1% of their purchases back as a cash reward. (By year end, we'll have returned more than $7 billion to Discover Cardmembers since the program began.) Discover® Card also came with 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 have built on them. For example, this year we introduced the Discover Motiva Card. Another industry first, Motiva provides an extra reward in the form of interest relief 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.

---

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 also operates the Goldfish credit card business in the United Kingdom.

[2] This statement responds to the questions the Subcommittee asked Discover to address in its letter of November 20, 2007.

This encourages payment behavior that avoids late fees and interest rate increases while also lowering the balance owed on the account.

We continue working to understand what our customers want, and then try 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, and help our customers manage their accounts. This is working: charge-offs are near historic lows.

- We don't outsource loan origination or loan servicing: every Discover® Card we issue is underwritten by us, held in our portfolio, and serviced by Discover. We view the customer relationship as a long-term arrangement - and so do our Cardmembers. Discover has ranked number one in the industry for customer loyalty 10 years in a row. [3]

- 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. Our staff members know our products, and how our customers want to be treated.

- We don't walk away from Cardmembers who experience problems. We offer account management information to all Cardmembers, and proactively reach out to offer assistance to those who appear to be having difficulties, as demonstrated by repeated minimum-only payments, overlimit transactions, or late or missed payments.

With 50 million Cardmembers, it is not possible to please everyone, but we think we do a good job responding to Cardmembers' expectations. We're proud that Discover recently received high marks from credit cardholders in the JDPower & Associates customer satisfaction study. Discover was the only credit card that ranked first or second in every category covered by the study. Consumers reported that Discover had the lowest incidence of problems among the 10 largest issuers, and ranked us highly for problem resolution. We ranked second for "fees and rates." (Incidentally, when JDPower asked cardholders to rank the 5 credit card features that are most important to them, "fees and rates" came in fourth, behind benefits, rewards and the billing and payment process, and above "problem resolution.")

Having discussed some of the features and customer service components of our cards, let me now address the manner in which we set the interest rates for them, and how those rates can change.

---

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

Risk-Based Pricing

Like other card issuers, Discover's practices in this area have evolved over time as we have developed the ability to better target offers and have become increasingly sophisticated in managing individual consumer risk. This has allowed Discover and other credit card banks to move beyond a one-product, one-price-fits-all credit card environment. Credit card loans, unlike home mortgage or car loans, are not one-time extensions of credit with balances that decline over time and are secured by assets that can be repossessed if the borrower defaults. Credit cards provide open-end credit lines that the borrower can access over the life of the account as needed. Every card transaction is a new extension of credit, dependent solely on the borrower's ability and willingness to repay. This makes it difficult - and risky - to underwrite, and price, the loan based solely on the borrower's creditworthiness at the time of application.

The ability to make risk-based and default-based price adjustments to annual percentage rates (APRs) allow us to offer credit to a wider segment of the public, and to price credit at a level appropriate for each borrower. Lower risk customers are offered higher credit lines and lower APRs, so many credit card users have seen the costs of credit come down. Higher risk customers - those more likely to default on their loans - receive lower credit lines, and are subject to higher APRs if they carry a balance- - but they have a better chance than in the past of qualifying for the credit they need.

Risk-based pricing provides tangible benefits to consumers. Its use has allowed interest rates for credit cards to decline, even though many of the costs of extending credit have not. In the words of former Federal Reserve Chairman Alan Greenspan:

> "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." [4]

Establishing an Account APR

Discover uses proprietary risk-modeling programs to identify the characteristics of existing customers that are associated with responsible credit usage and payment behavior. We compare these to attributes of new credit card applicants and to customers whose risk is being evaluated in connection with applications for higher credit lines or as part of a portfolio review. Information from the consumer (furnished on the card application) and from other sources, notably consumer reporting agencies, is also used to gauge the individual's repayment capacity, past use of credit, current debt level, and the extent to which other credit lines are being utilized. This information is used to derive internal custom behavior scores that predict the likelihood that a customer will repay the credit we extend, based on our own and other lenders' experience with the individual and similar customers.

---

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

Of course, credit card pricing involves more than just an individual accountholder's default risk. The price of credit also must reflect all of the costs of offering it, and a portion of these costs must be borne by every customer, regardless of their level of credit risk. These costs include the costs of the funds we borrow, fraud losses, information technology expenses, operational costs (such as the cost of processing and mailing millions of monthly statements), customer service expenses, collection costs, and regulatory compliance costs. Setting a price that an individual will pay must be based on our best estimate of what these costs will be, but marketplace circumstances inevitably intervene, making the process of estimating expenses difficult indeed.

Our pricing models are constantly updated, tested and improved not only to meet our needs and those of our customers, but also the interests of some important third parties. Because our cards are issued through a federally insured depository institution, Discover Bank, we must demonstrate to our regulator, the Federal Deposit Insurance Corporation, that our risk management techniques are adequate to prevent losses to our portfolio, the deposit insurance system, and ultimately the taxpayer. Bank regulators require institutions engaged in credit card lending to do so "in a safe and sound manner by establishing sound account management, risk management and loss allowance practices." [5] The regulators are quite familiar with risk-based pricing and understand its importance as a risk management tool. They require us to document and analyze decision factors we utilize, such as repayment history, risk scores, behavior scores and other criteria. We also must demonstrate to them that our risk modeling systems conform to the requirement of the Equal Credit Opportunity Act that they be "empirically derived and statistically sound."

Risk-based pricing also addresses investors' expectations that returns be commensurate with the unique risks and costs associated with unsecured credit card lending. Both our own shareholders and investors in Discover securities backed by credit card receivables [6] expect us to extend credit responsibly and prudentially. Risk-based pricing is an important tool that supports our ability to meet those obligations.

Changes in Interest Rates

The annual percentage rate that an individual cardholder pays can change for several reasons, such as (1) changes in the underlying index to which a variable APR is linked or the expiration of a temporary APR, (2) changes driven by the customer's payment behavior ("default-based pricing), and (3) changes to the account's pricing terms made to reflect changes in cost or risk to the portfolio ("risk-based pricing). Default-based and

[5] "Account Management and Loss Allowance Guidance for Credit Card Lending" issued jointly by the Office of the Comptroller of the Currency, FDIC, Federal Reserve and Office of Thrift Supervision, January 8, 2003.

[6] Discover Financial Services became a public company on July 1, 2007, with shares trading on the New York Stock exchange. Discover regularly securitizes its credit card receivables, an increasingly important means of funding our lending.

risk-based APR changes are discussed below[7]. Cardmembers are informed of the manner in which their APRs may change in the Cardmember Agreement they receive at the time the account is opened. If these terms change, notification is given in advance, and the customer can choose to avoid the new terms by closing the account and paying off the current balance under the existing terms.

1. Default-Based Interest Rate Changes

Default-based credit cards provide that the APR will increase if the customer "defaults" on his or her obligations. Under the default rate plan in the current Discover Cardmember Agreement, default means the failure to make a required Discover Card payment - of at least the minimum due - on time. (This is not a "universal default" plan where an APR increase is triggered by a default - missed payment - with another lender).

For a number of reasons, most accounts that experience a payment default are *not* repriced under the Discover plan. When an account is repriced, the default APR is not the same for all customers who miss a payment, and the APR does not automatically increase to the maximum default-rate APR (currently 28.99%). It may instead go to an APR between the pre-default rate and the maximum. The default APR for a specific account, and the percentage above the pre-existing rate at which it is set, is based on a variety of factors, such as the current APR, the customer's payment history on the account, and the customer's overall debt management behavior. This allows Discover to differentiate between customers whose missed payment is an indicator of a risk that future payments will not be made and the account may ultimately charge off, and those for whom the missed payment does not appear to signal a long-term problem.

a. Avoiding Default-Based APR Changes

Unlike APR changes on variable rate credit cards that are triggered by decisions at the Federal Reserve and financial market events over which the customer has no control, default-rate changes are completely within the control of the customer. They can be avoided by making timely payments, and most Discover Cardmembers do just that. In fact, late payment behavior has declined over time. For one thing, a growing percentage of our Cardmembers pay us via the Internet and are readily able to avoid late payments and fees - and default-based APR increases - by scheduling their online payments to be made on or before the payment due date. Others avoid late payments by making pre-authorized debit transfers or no-fee telephone interactive voice response payments. Many

[7] Variable APR cards tie the interest rate to an external index, generally the Prime Rate. They reduce the lender risks associated with increases in the cost of funds, and allow cards to be offered at lower APRs. When the index rate (e.g., Prime Rate) changes, the APR changes with it - increasing or decreasing. As with other variable rate credit products, like home equity loans, APR adjustments apply to the current balance as well as to future extensions of credit. Cards that carry introductory or promotional APRs are similar. When the temporary introductory or promotional time period ends, the APR automatically adjusts to a predetermined APR in accordance with the terms of the offer, and applies to any portion of the balance that the customer has not paid down during the introductory/promotional period.

take advantage of our no-fee e-mail reminders, sent a few days before the due date, a service we pioneered.

b. Automatic Re-Adjustments of Default-Based APRs

The small percentage of Discover Cardmembers who experience an APR increase because of a payment default have an opportunity to return to a lower APR. If these customers make nine consecutive on-time payments of at least the minimum due, the APR for new purchases is automatically reduced, and the APR on any existing balance is eligible for a reduced rate. For these customers, the default-based APR increase has a short-term impact. The amount of the APR reduction, like the amount of its increase, depends on the current risk profile of the customer. In some cases, the rate reverts to the rate in effect prior to the default. Otherwise it will be set at a level between the pre-default and default-rate APR.

c. Impact of Default-Based APR Increases

We are sometimes asked why a lender would increase the APR on an account that shows signs of increased risk. Doesn't a higher APR actually *increase* the risk that the customer will fall behind and perhaps default on the loan? The answer, in a word, is "no." The last thing that any lender wants to do is to increase the odds that the loan will not be repaid. 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. We take all necessary steps to make sure that does not happen.

We continually evaluate the default rate program, and make adjustments, if necessary, to make sure that it does not have an unintended impact or harm at-risk customers. Our models exclude accounts from default-based (and risk-based) repricing if there are signs that the customer would not be able to make the payments at the higher APR. We compare the performance of accounts that are repriced with the performance of accounts of customers with similar risk profiles that are not repriced in order to be assured that the program does not increase the likelihood of default. Our experience demonstrates that it does not.

Default-based pricing has been successful in identifying, and allocating costs to, customers most likely to default, while creating incentives for them to avoid future default. Customers respond to repricing in a number of ways:

- For many, the higher APR is a reminder that results in behavioral changes. In some cases, the customer simply becomes more diligent about meeting payment deadlines. The account APR is automatically reduced once on-time monthly payments have been made.

- Other customers react by changing their purchasing behavior (reducing purchase or cash advance transactions or stopping them altogether), so that payments amortize the account balance more rapidly, even at a higher APR.

- Some cardholders change their payment amounts: minimum-payment or low-payment customers may begin making larger payments, again reducing their long-term costs. In some cases, the entire balance is repaid, sometimes from savings, sometimes with funds borrowed elsewhere (such as home equity lines, or low-APR balance transfers to other credit card lenders).

- Another group of customers receive relief from the higher APR by contacting Discover directly, or indirectly through credit counseling programs. They may enter into payment arrangements that involve APR relief, fee waivers, reduction in principal or a combination of payment concessions. In cases where the customer's risk profile shows signs of improvement, interest rate reductions may be offered to encourage the consumer to remain a Discover Cardmember.

3. Risk-Based Interest Rate Changes

Risk-based APR changes are not triggered by a payment default with Discover, but are based on other signs of changes in the underwriting and portfolio risk information that was used at the time a customer's account was opened or the current APR was assigned to the account. A customer's payment record with Discover is not the only pertinent indicator of risk. Just as an automobile insurer considers more than just timely premium payments in setting rates to cover future claims (e.g., information about where the policy holder lives, age group, accident claims and driving infractions), credit card lenders need to consider a borrower's total credit picture in evaluating the likelihood of future default. Information about how a customer uses credit extended by others may dictate a need to update credit decisions made at an earlier time. Changes in a customer's credit attributes (e.g., high utilization of credit lines, persistent minimum-only payments, recent changes in spending or payment behavior, excessive uses of cash advances, growth in the number of credit accounts) may signal a need to reevaluate the APR for the account. For example, individuals whose FICO scores decline by what might appear to relatively small number of points represent a substantially greater charge-off risk.

In some cases, the need to change pricing for a segment of the portfolio is driven by changes in the business, regulatory or competitive environments that increase costs or reduce revenues. Repricing of a portfolio segment allows credit card lenders to adjust pricing to risk and cost over time, as these changed circumstances require.

Risk-based APR changes are not made frequently and do not affect large segments of our customers. They are made when necessary and are targeted to carefully defined customers or groups.

Moreover, risk-based APR changes are not unilateral changes that the customer must accept. When changes in individual risk or portfolio risk lead to a decision to change the APR or other pricing terms of an account, the customer receives a change in terms notice that explains the new provision. The Truth in Lending Act currently requires these notices to be sent to the consumer 15 days in advance of the terms change. In Delaware, where Discover Bank is located, the law requires that customers also be given an opportunity to pay off the existing account balance at the APR that was in effect before the change was made. Card issuers are required to send customers an explanation for a change in terms that adversely affects the customer. This “adverse action” notice must identify the specific reasons that led to the decision or offer the customer the opportunity to obtain that information, and inform the customer of the right to dispute information from credit bureaus that was used in the decision making if the customer believes it was inaccurate or incomplete.

a. Impact of Risk-Based APR Changes

Customers affected by risk-based price increases, like those whose APRs increased because they defaulted on payments to Discover, respond in a variety of ways. Some customers take advantage of the opportunity to make payments on the existing balance under the “old” account terms, and close their accounts before the higher APR takes effect. Others pay off the balance in full or move it to another credit card that offers a lower balance transfer rate. Many customers do not make a change. They continue to have access to their credit card for future purchases and make payments at the higher APR. The impact of the APR change on these customers depends on amount of the increase, the size of the account balance and the dollar amount of the payments the customer makes. The change does not affect customers who do not carry a balance (a large segment of card users) and would have a minimal impact on those who carry a small balance or who increase their monthly payments in order to pay off the higher-APR balance quickly.

b. Re-adjustments of Risk-Based APR Increases

All customers whose risk profiles improve are eligible for APR reductions during regular portfolio reviews that adjust price to risk. I mentioned previously that Discover customers subject to default-based APR increases can “earn” a lower APR automatically by improving their payment behavior through on-time payments. We are currently testing ways to provide similar opportunities to customers whose APRs are increased through risk-based terms changes. These customers are now eligible for reduced rates when there is an improvement in the risk factors on which the APR increase was based, and receive automatic deceases when variable rate APRs move downward. We are examining the impact of tying APR reductions to specific payment behavior, account usage, or other criteria.

As you know, the Federal Reserve Board has recently proposed that the change of terms notice for risk-based price increases be sent 45 days in advance of the change, not 15 days, and that all credit card holders (not just customers of Delaware-based banks) be given a right to opt out of the change – and repay the existing balance at the old rate. This proposal would treat an APR increase made under default-rate plans in the same manner, so that there would be a 45-day delay in imposing an APR increase after the customer default, and the customer could elect to opt out of the increase altogether. These changes, which we expect will be adopted essentially as proposed, will address many of the questions that have been asked about the impact of default and risk-based pricing and cardholders’ ability to respond to them.

Conclusion

Our pricing models have increased in sophistication and effectiveness. Risk-based pricing enables us to provide needed credit to a wider spectrum of consumers at prices tied to individual behaviors. While consumers at the highest risk levels pay more, risk pricing provides them with access to credit from legitimate regulated lenders. For most consumers, risk-based pricing means lower APRs, more choices, and improved credit card products.