Docket No. R-1314 (Regulation AA)
Meeting at the Federal Reserve Board on July 22, 2008

On July 22, 2008, representatives from Discover Financial Services ("Discover") met with Governor Randall Kroszner to discuss the Board's proposed rules under the Federal Trade Commission Act (Regulation AA).

The meeting was attended by David Nelms, Ray Messina, and Kelly McNamara Corley on behalf of Discover. Also in attendance were Sandra Braunstein (Director of the Board's Division of Consumer and Community Affairs), Scott Alvarez (the Board's General Counsel), and other members of the Board's staff.

Discover's comments regarding the Board's proposal are set forth in the attached document.

Discover Financial Services

Board of Governors Federal Reserve System

July 22, 2008

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Discover Background

- **Credit card lender and payment network since 1986**
- **S&P 500 company since 2007**
  - 45+ million cardholders
  - Payments business—Discover Network/PULSE/Diners Club ($220 billion/year spending)
- **Innovator**
  - First to offer no annual fee
  - Cash rewards
  - 24/7 customer service
  - Motiva
  - Only successful new network since 1960's
- **Tailored approach to assist customers with financial hardship**
- **Sophisticated models**

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Credit Card Industry Timeline

The Evolution of the Credit Card Has Generated Value for Consumers and the Economy

Mid 1980's
- Discover launched – Pioneered no annual fee, cash rewards

Early 1990's
- Broader range of APRs. Industry moves to no annual fee

Mid 1990's
- Low introductory offers & low APR, balance transfers, phone payments

Late 1990's
- Internet payments, debt management tools, more prevalent credit assistance for distressed customers

Early 2000's
- Extended fraud protection, enhanced rewards, new internet usage and payment options

Today
- Product to reward responsible credit use introduced – Motiva by Discover

MID 1980's
- **18.9% typical APR offered**
- **annual fee**
- **no rewards**
- **limited access**
- **infrequent offers**
- **less competition**
- **limited ability to switch**

Greater access to credit →

Lower rates →

Rewards and other benefits →

Broad acceptance and usage →

TODAY
- **12.5% avg. APR offered**
- **wide APR range, 13.7% avg. APR**
- **no annual fee**
- **rewards prevalent**
- **widespread access**
- **frequent offers**
- **highly competitive market**
- **many options for customers**

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Source APRs – Federal Reserve Statistical Release, EOY 1985 & Feb 2008

Note(s)
APRs are based on average APR offered to customers

Current Environment

- **Increasing financial stress on consumer**
  - Reduced availability of mortgages, home equity products, student loans
  - Rising unemployment, energy costs, food costs
  - Open-end credit availability critical:
    - ➢for consumers
    - ➢for small business/retailers

- **Industry's challenges**
  - Funding less available, higher cost
  - Capital shortages at many banks and financial institutions
  - Increasingly difficult to meet consumer demand due to cost and market conditions
  - Rising delinquencies and charge-offs
  - Uncertain impact of accounting rule changes (FAS 140)

Regulatory Objectives

Discover believes credit card regulation should achieve the following objectives:

- Recognize the unique benefits and characteristics of open-end, unsecured lending
- Provide clear and meaningful disclosures
- Maintain credit availability
- Foster innovation and robust competition
- Encourage/reward responsible credit usage
- Promote financial institution safety and soundness, and liquidity
- Prospective application/transition period

Regulatory Objectives (cont'd)

Meaningful regulatory changes do not require "unfair or deceptive" characterization

- Misapplication of FTC Act standard creates uncertainty regarding previously accepted practices
  - FTC Act standard:
    - Substantial injury to consumer
    - Injury not outweighed by benefits to consumer or competition
    - Injury not reasonably avoidable
  - FTC Unfairness Policy Statement @1073: "If consumer reasonably could have made a different choice, the practice is not unfair"
- Approach creates uncertainty about "fairness" of many other previously accepted and future industry practices – no safe harbor
- Approach introduces litigation risk by branding previously authorized practices as "unfair or deceptive"
  - *e.g.*, two cycle billing: authorized by Regulation Z, Section 226.5a(g)(2)
- Suggested alternatives:
  - Changes should be addressed through Regulation Z
  - Specify that any practices deemed prohibited will be on a prospective basis only

Concerns Regarding FRB Proposals

Several Proposals Will Have a Significant Financial Impact on Consumers and the Economy

UDAP Proposals	Industry	Consumer	Economy
Restricted ability to reprice the customer based on an "on us" default Restricted ability to adjust rates on existing balances Payment allocated to promotional balances last; lowest-to-highest allocation not allowed	More difficult to manage credit and interest rate risk Industry put at risk for past practices previously authorized and accepted Stress on financial system, liquidity, safety and soundness	Reduced access to credit and credit card products for large number of customers Higher rates for new account customers Reduced frequency and quality of promotional offers Limited ability to offer credit assistance Reduced rewards	Further tightening of credit markets (could result in less access to affordable credit for millions) Decrease in overall consumer spending –Consumers may have difficulty making purchases online –Adverse impact on retail sales and discretionary purchases –Adverse impact to traditional credit card use (e.g., gas, internet, etc.) Consumers unable to obtain low-cost credit will pay higher rates on cards or seek higher-cost loans (auto title, payday) Stress on financial system, liquidity, safety and soundness

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FRB Proposal

Restricted Ability to Reprice the Customer Based on an "On Us" Default

- **Current practice**
  - Default triggers disclosed in account agreement
  - 2/3 of our delinquent customers excluded from default pricing today
  - 60% of default customers do not receive maximum default APR
  - Automatic cure for 9 consecutive on-time payments
- **Unintended consequences of 30-day default trigger**
  - Reduced availability of credit (i.e., millions of consumers will have less access to low cost credit)
  - Higher rates, estimate 250 – 300 bps overall increase for new accounts offers
  - More difficult for industry to manage risks
    - ➢30+ days late customers have >50% likelihood of charge-off
    - ➢We decrease APR for distressed customers in many instances
  - Decrease in overall consumer spending affecting retail sales and discretionary spending
  - Stress on financial system, liquidity (*e.g.*, securitization), safety and soundness
- **Recommended approach**
  - Clarify disclosure
    - ➢Statement notice of implementation of default rate
  - Include other permissible default triggers (*e.g.*, recurring events)

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FRB Proposal

Restricted Ability to Adjust Rates on Existing Balances

- **Current practice**
  - Targeted and measured approach to align pricing with customer's changing financial condition and behavior
  - Prior disclosure and 45-day opt out
  - 30% of customers have had a Discover Card for 15+ years, half of those customers have a lower APR than originally booked

- **Unintended consequences**
  - Unable to adjust to customer's changing financial condition and behavior
  - Ignores statistically sound and empirically derived data reflecting charge-off risks
  - Restricts flexibility to offer lower and more stable rates
  - Restricts ability to manage customer behavior before default

- **Recommended approach**
  - Provide additional notification (*e.g.*, statement) and opt out mechanism (*e.g.*, phone) allowing for opt out to extend beyond statement date
  - Permit repricing at account expiration with opt out opportunity

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FRB Proposal

Payments Allocated to Promotional Balances Last; Lowest-to-Highest Allocation Not Allowed

- **Current practice**
  - Promotional offers benefit customers by reducing overall APR average
  - Clear disclosure on how payments are applied
  - Enables money-saving balance transfer offers (25% of customers have taken advantage of offers over past 5 years)
  - Frequently used by customers to consolidate/pay down debt

- **Unintended consequences**
  - Current promotional offers are based on existing industry-wide payment allocation methods. Changed economics will result in significantly reduced availability and duration of promotional offers
  - Will result in higher customer average APRs

- **Recommended approach**
  - Preserve current allocation method
  - Enhance disclosure