Testimony of Capital One Financial Corporation

Senate Banking Committee

May 17, 2005

Good morning, my name is Marge Connelly, Executive Vice President, Capital One Financial Corporation, and I am pleased to appear before you today to talk about the state of the credit card industry.

Overview

Capital One is one of the largest credit card providers in the world, and a diversified financial services company with over 49 million accounts and $81 billion in managed loans outstanding as of March 31, 2005. In addition to credit cards, we are one of the nation's premier auto finance companies, and also offer our customers an array of other banking and related products and services. We employ nearly 15,000 associates worldwide, with offices around the country and overseas. Earlier this year, Capital One announced its planned acquisition of Hibernia Corporation, a financial holding company headquartered in New Orleans that has over $21 billion in assets and offers a full range of deposit products and a wide array of financial services through more than 300 locations in Louisiana and Texas.

Capital One, along with the other companies testifying before the Committee, has played a leading role in building the national credit superhighway that, in the past 15 years, has greatly advanced economic democracy in America. While credit card lending is only a small percentage of consumer credit—about four percent[1]-- its real contribution lies elsewhere. The credit card is

---

[1] *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances,* Federal Reserve Bulletin, January 2003, Chart 10, page 21.

now one of the consumer's main contacts with the payment system,[2] and has fostered a vast national transformation that has changed commerce for the better.[3] Using payment cards, consumers can conduct everyday transactions without writing checks and without having to do the associated recordkeeping. Consumers can shop by telephone or the internet at a time and in a setting that is convenient for them, saving both time and money while increasing consumer choice.

As with all significant social and economic changes, this transformation has been accompanied by its share of controversy, and Capital One is grateful for the opportunity to participate in the Committee's exploration of the issues surrounding the credit card industry today. But first, it is necessary to spend some time understanding payment cards' development and role in society.

Democratization of Credit and the Transformation of Commerce

Developments in information technology and the availability of consumer credit information spurred major changes in the credit granting process. The beginnings of a national consumer credit market were acknowledged in the passage of the Fair Credit Reporting Act (FCRA) in 1974, updated by this Committee in 1996 and most recently in 2003. Credit became more widely available on a national basis, as credit bureaus developed large databases that provided lenders with a more holistic and consistent view of a particular consumer's risk characteristics. Nevertheless, pricing was still not highly differentiated, and approximately half of the eligible U.S. population could still not qualify for a credit card.

---

[2] *Credit Cards: Use and Consumer Attitudes, 1970-2000,* Federal Reserve Bulletin, September 2000.
[3] *Ibid.*

Even as late as 1987, the credit card market was mired in a "one size fits all" approach, characterized by uniform interest rates and annual fees.

Largest Ten Issuers (1987)	**APR**	**AMF**
Citibank	19.8%	$20
Bank of America	19.8%	$20
Chase Manhattan	19.8%	$20
First Chicago	19.8%	$20
Wells Fargo	19.8%	$20
First Interstate	19.8%	$20
Manufacturers Hanover	19.8%	$20
MNC Financial	19.8%	$20
Marine Midland	19.8%	$20
Security Pacific	19.8%	$20

The market was ripe for innovation, and the founders of Capital One saw an opportunity to use the information provided by our national credit reporting system to customize product offerings to customers based on their particular needs, interests and risk profiles.

Our founders realized that the "one size fits all" approach made little sense when each consumer possessed vastly different needs and characteristics. While some consumers were risky, many more were less so – in varying degrees. Without the ability to differentiate one from another, however, lenders were compelled to raise prices to cover the cost of higher credit losses, or to cut back on the granting of credit to reduce the losses. Either way, consumers suffered.

The less risky customers were paying too much, and for the rest, credit was hard to come by – if available at all.

Capital One was able to use information within the legal framework provided by the FCRA to make significant advances in underwriting – better distinguishing the risk characteristics of our customer base. The benefits of greater access to better information went beyond risk analysis, however. Capital One and other companies were also able to use information to create profound innovations in the marketing and design of credit cards. Our company led the charge with new product ideas like balance transfers, where customers could shift balances away from high-priced cards to our lower-priced offerings, and low introductory rates. The resulting reductions in price and expansion of credit into traditionally underserved markets sparked a consumer revolution that can fairly be called the "democratization of credit."[4]

By this decade, the desultory competition and flat pricing structure of old were no more. In their place came fierce price competition which has produced billions of dollars in savings for consumers across the country.

Largest Eight Issuers (March 2005)	Lowest Long-Term APR	AMF
Capital One	4.99 % Variable	$0
Chase/Bank One	7.99% Fixed	$0
Bank of America	5.25% Variable	$0
MBNA	5.25% Variable	$0
Providian	7.24% Variable	$0

[4] *The Fair Credit Reporting Act: Access, Efficiency & Opportunity*, Information Policy Institute, June 2003.

American Express	8.24% Variable	$0
Discover	5.99% Variable	$0
Citibank	7.99% Variable	$0

These numbers actually do not capture all the savings to consumers caused by increased competition, because they do not take into consideration the widespread availability of low introductory and balance transfer rates.

The last 15 years also saw significant developments in the pioneering of affinity cards, with benefits for consumers and the organizations they most value; rewards programs which provide consumers with value added benefits ranging from airline miles to college savings plans; and co-branded products, which allow consumers to enjoy discounts and other privileges at their favorite retail outlets.

The power of this heightened competition has not been lost on consumers – in just ten years as an independent company, Capital One has grown its account base from 5 million to 49 million worldwide – all without the once vital "bricks and mortar" network of branches. We can give consumers the best deals no matter where they reside – from mid-town Manhattan to the smallest farm community in Iowa.

For consumers, the benefits are self-evident: prices for credit continue to decline and availability to widen – most notably in the traditionally underserved low- and moderate-income communities.

In addition to the direct economic benefits of lower pricing, consumers have received an equally significant qualitative benefit from advances in the payment card industry, and that is the transformation of everyday commerce. Credit cards serve as a "payment device in lieu of cash or checks for millions of routine purchases as well as for many transactions that would otherwise be inconvenient or perhaps impossible,” [5] such as making retail purchases over the internet or telephone. The explosion in internet commerce, and indeed the establishment of whole new marketplaces such as E Bay, could not have occurred without the relatively recent development of payment cards. With the advent of payment cards in the 1950s, consumer debt has had two components: non-revolving debt, consisting of traditional installment-purchase type loans for such things as appliance purchases, and revolving debt, consisting of “prearranged lines of credit.”[6] Since the late1960s, revolving debt has increasingly replaced non-revolving debt, and some of this revolving credit is “convenience credit” that replaces cash and is paid in full every month.[7] As noted above, credit card debt composes around four percent of all consumer debt, but it is erroneous to look at this as unqualified new debt for the reason just cited -- the rise in revolving debt since the late 1960s has been accompanied by a decline in non-revolving debt (relative to income) while overall consumer debt has remained fairly constant relative to income.[8] This is not to say that a portion of credit card debt is not new in the sense that it is in addition to, rather than in replacement of, other debt the consumer would have incurred; but that new credit does not appear to be a large part relative to income. Critics of the industry portray credit-card debt as a massive debt burden for the American consumer, but the size of the debt as a component of overall consumer indebtedness does not support that charge. Where payment cards clearly have had a pervasive impact, out of proportion to the amount of credit that they represent, is in their economic functionality—as a substitute for cash and checks, and as an enabler for new marketplaces and forms of commerce.

[5] Federal Reserve Bulletin, September 2000, page 623.
[6] *Ibid,* page 624.
[7] *Ibid, Chart 1”Consumer credit outstanding as a proportion of disposable income, 1956-1999,* page 624.
[8] *Ibid.*

The Challenges of Successful Competition

As the above discussion helps to emphasize, there is no more competitive industry. Several thousand financial institutions issue general purpose credit cards such as MasterCard and Visa, in addition to those issued by American Express, Discover and many retailers. As many as 50 of the largest credit card issuers distribute their cards nationally, Capital One among them. Obviously, this market is not dominated by any one issuer. There are few barriers to entry and exit. In recent years, newcomers such as Juniper Bank and the banking arm of State Farm Insurance have taken market share from more established issuers,[9] contributing to the pressure on all market participants to focus on products that best serve consumers.

In the face of this intense competition, each day at Capital One, our associates work hard to retain our existing customers, acquire customers new to the market, and attract the customers of our competitors with better offerings. This nationally competitive environment has completely displaced the balkanized, localized credit card markets of 30 years ago – markets that featured high, largely undifferentiated pricing combined with an onerous and highly subjective application process and limited availability and access to credit.

As a result, the industry now plays a preeminent role in the day-to-day lives of consumers. Capital One has 38 million U.S. credit card accounts, and any one of those customers can drop our product and immediately get a replacement from any one of at least ten major competitors. We live by and for our customers, and we are committed to retaining them.

There have been many complaints that credit card fees are too high – in particular, fees for infractions of account rules (late fees, overlimit fees, returned-check fees). But in fact, the rise in these fees corresponds with the industry's movement toward lower interest rates and annual membership fees on accounts generally, as credit card lenders compete fiercely to offer

---

[9] *Credit Cards, 2003,* SMR Research.

consumers what they most want. Consumers have voted for those low-rate and low-membership-fee products by signing up for them – and leaving those products with higher rates and membership fees. But in order to offer those low rates, and those zero-dollar membership fees, it has become critically important for credit card lenders to manage risk in their accounts more effectively, including the use of default fees to compensate for the added risk of those customers who do not abide by the account rules.

Because it is so easy for consumers to switch credit card issuers – and millions do so every year -- credit card companies must take very seriously any suggestion that our customers are not being treated fairly. As competition intensifies and credit products become more complex, it becomes more important to be sure that customers understand the terms of their accounts and are not surprised by any fees or charges they may incur, or changes in terms. In other words, it is not enough to have built the national credit superhighway with all of its speed and cost benefits, but we must ensure that it has good road signs and exits—all without impeding traffic flow or imposing unreasonable tolls. Capital One has some proposals in that area, but before discussing those, it is vital to achieve a common understanding of open-end credit and the underwriting process.

Open-End Credit and the Underwriting Process

Open-end, unsecured credit is just that—it is credit that is extended in variable amounts over an indefinite period of time with no collateral to secure the debt. The lender extends or "underwrites" this credit solely on its analysis of the consumer's likelihood to repay. A "snapshot" of the consumer's ability and willingness to repay at a given point in time must support a lending decision that can have consequences indefinitely into the future. There is no collateral, as with auto or mortgage loans. Prior to the development of open-end credit delivered through credit cards, the consumer would apply for an installment purchase loan for a particular good or purpose. The loan was for a fixed period of time. If a consumer purchased a refrigerator, the lender would assess the likelihood to repay for that particular item and offer a rate based on the particular risk factors involved. The credit was extended only in a specific amount for a specific period of time. The lender's risk was limited to that amount and time period, and even within that time period, the lender's credit risk declined over the life of the loan as the customer paid down the loan according to the prescribed schedule. If the consumer next wanted to buy a washing machine, the process started all over again, and if the consumer's risk profile had changed, he or she could get a different rate, or not be granted credit. With open-end credit, the consumer receives a prearranged credit line and can make subsequent purchases up to the credit limit without any further approval process. The lender's exposure is for an indefinite period during which the borrower's creditworthiness can fluctuate considerably.

In unsecured lending, if the lender is to make money (or even stay solvent), every bad loan must be compensated for by many good loans. And the rate charged on those loans must reflect their risk. To illustrate why that is so important, consider a simple example.

The example, shown in the chart in Attachment I, consists of two simple loan portfolios, each containing 100 loans of $1000 apiece. One portfolio has an interest rate of 19.9%, similar to prevailing credit card interest rates of two decades, ago, the other a rate of 6.9% similar to prevailing rates today.

If one loan in the 19.9% portfolio defaults, it takes the interest from 10 performing loans to compensate for the default. But if one loan in the 6.9% portfolio defaults, it takes the interest from 29 performing loans to compensate for the default.

The importance of accurate underwriting in today's more-competitive interest rate environment is obvious. The challenge for every lender is to fit the maximum number of borrowers into the continuum of rates that that lender charges while keeping defaults to a minimum. Whoever does the best job of fitting borrowers to a particular interest rate attracts the most customers, because that lender can offer the lowest rate and manage defaults so that the lender still makes money. When a lender extends open-end credit, it is vital that, to the extent possible, the lender keeps the consumer in the right credit portfolio during the life of the credit relationship; otherwise the lender's underwriting failure unfairly distributes cost to other consumers and imperils the lender's ability to remain in business. Anything that enhances this process has obvious consumer benefits, and anything that disrupts it has equally negative consumer effects.

Because credit-card lending is unsecured, accurate underwriting is a matter of the lender's financial life and death. And because credit-card lending is open-ended, it requires special tools to manage risk over the indefinite future during which the customer's behavior and creditworthiness may change. These tools include fees for rule violations, and the ability to modify credit lines, and suspend or terminate the account, and the ability to reprice, or re-underwrite, the account. As noted above in the comparison of closed-end vs. open-end credit, closed-end credit is a discrete underwriting event where the underwriting can be adjusted with each purchase, whereas the indefinite nature of open-end credit increases the risk of meaningful changes in credit quality. The ability to price for risk in either a closed or open-end context is vital to expanding access to credit while maintaining an appropriate distribution of rates for all borrowers.

Proposals for Change

Keeping all of that in mind, let me return to the question how the industry can improve the signs and exits for the consumer who is driving along the credit superhighway. First, an example of an effective sign is the "Schumer Box" that currently accompanies credit card solicitations. It prominently and efficiently discloses a number of key terms for the consumer. Building on the strengths of the Schumer Box, we have submitted to the Federal Reserve, pursuant to their Advance Notice of Proposed Rulemaking for Regulation Z, a proposal to enhance solicitation disclosures as illustrated by the Fact Sheet in the poster before you and in Attachment II to my statement.

After listening to consumers whom we gathered in a number of focus groups (not Capital One cardholders, except by chance), we synthesized the following principles, which we reflected in the Fact Sheet:

a. Importance
b. Comparability
c. Clarity
d. Simplicity
e. Specificity

Applying those principles, we produced our Fact Sheet, including a number of changes from the current disclosure regime:

- More prominent and standardized disclosure of events that may give rise to changes in the customer's interest rate; moving those disclosures from where they currently appear, in footnotes to the Schumer Box, into the heart of the Fact Sheet

- Disclosure of the range of credit limits that the customer may receive (not currently required or permitted to be disclosed in the Schumer Box)
- Disclosure of certain fees not currently required to be in the Schumer Box
- Disclosure of other matters of importance to prospective customers: we propose disclosing the manner of payment allocation

We look forward to working with the Federal Reserve Board on their important project to bring Regulation Z and the credit-card disclosures that it governs into the 21st century.

Conclusion

To conclude, Capital One wants our customers to be well-informed and financially literate. Well-informed customers are the most likely to understand and appreciate our products, and to use them wisely. Effective, standardized disclosure is key to achieving that goal, and that is why the Federal Reserve review of Regulation Z is so important. Capital One looks forward to actively and constructively participating in this process to bring about meaningful improvements to the industry. Again, we appreciate this opportunity to present our views to the Committee.

Attachment I

$1000 loans made to 100 borrowers (principal = $100,000) to be paid in one year (no compounding, regular monthly payments)

	Scenario 1	Scenario 2
Interest rate	19.9%	6.9%
Value of each loan (paid in one year; paid regularly over the year)	≈ $1,099.50	≈ $1,034.50
Effective rate of return	≈ 10%	≈ 3.0%
Value of the portfolio	$109,950.00	$103,450.00
The non-performance of one of the 100 loans = the interest payments of	10 borrowers	28.99 borrowers
To earn expected profit (in $) at given interest rate on the assumption that one borrowers will default at the outset, loans must be made to	110 borrowers (=starting principal of $110,000.00)	128.99 borrowers (=starting principal of $128,990.00)
Effective rate of return (with one expected default and new borrowers/added principal to compensate)	9.04%	2.67%

At lower interest rates, the rate of return on each loan requires more borrowers to make up for each non-performer than do loans with higher interest rates. In Scenario 2, 28 borrowers are needed to safeguard the principal extended to one borrower. In Scenario 1, only 9 borrowers are needed to do so.

Attachment II

CREDIT CARD FACT SHEET

PRICING & FEES

X%min-X%max Variable	Purchase APR after Month/Year
X% Variable	Intro Purchase APR until Month/Year (PRIME + XX.XX%)
$X min-$X max	Initial Credit Line
$X (frequency)	Membership Fee
$X	Late Fee
$X	Overlimit Fee

X% Variable	Balance Transfer APR after account opening
X% Variable	Intro Balance Transfer APR
X% or $X	Balance Transfer Fee
X% Variable	Cash Advance APR
X% or $X min.	Cash Advance Fee
$XX	Minimum Finance Charge
X% or $X	Minimum Payment
XX days	Interest-Free Period for Purchases if balance is paid in full monthly
$XX	Return Check Fee

REASONS YOUR RATES MAY CHANGE

You pay late or you pay less than the minimum requested.	• [Up to] XX% Default APR(s) • (creditor specific information for reduction or elimination of default APR)
You break a rule on another account with us.	• [Up to] XX% Default APR(s) • (creditor specific information for reduction or elimination of default APR)
You break a rule on an account with another creditor.	• [Up to] XX% Default APR(s) • (creditor specific information for reduction or elimination of default APR)
You have negative information show up on your credit report.	• [Up to] XX% Default APR(s) • (creditor specific information for reduction or elimination of default APR)
Your transactions go over your credit limit.	• [Up to] XX% Default APR(s) • (creditor specific information for reduction or elimination of default APR)
Your check is returned – unpaid.	• [Up to] XX% Default APR(s) • (creditor specific information for reduction or elimination of default APR)
Your terms may change from time to time due to market conditions or other reasons.	• Changes will be made in accordance with applicable law and the Card Agreement that will be sent with your card.

ADDITIONAL INFORMATION ABOUT YOUR ACCOUNT

Your APR is a variable rate that changes monthly based on (Rate Index + XX.XX%).

Your payments and credits will be applied to balances with lower APRs before balances with higher APRs.

Please visit our website: www.creditcards.com or call us at 888.123.4567 for additional information.

This Standard Fact Sheet is used by all creditors. Please use it to make an informed decision.