Comptroller's Handbook A-IL

Safety and Soundness

Capital Adequacy (C) | Asset Quality (A) | Management (M) | Earnings (E) | Liquidity (L) | Sensitivity to Market Risk (S) | Other Activities (O)

Installment Lending

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Introduction

The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* booklet, "Installment Lending," is prepared for use by OCC examiners in connection with their examination and supervision of national banks and federal savings associations (collectively, banks). Each bank is different and may present specific issues. Accordingly, examiners should apply the information in this booklet consistent with each bank's individual circumstances. When it is necessary to distinguish between them, national banks and federal savings associations (FSA) are referred to separately.

This booklet is one of several specialized lending booklets and supplements guidance contained in the "Loan Portfolio Management," "Large Bank Supervision," and "Community Bank Supervision" booklets of the *Comptroller's Handbook*. This booklet addresses only closed-end consumer credit. For information related to open-end credit, refer to the "Credit Card Lending" and the "Residential Real Estate Lending" booklets of the *Comptroller's Handbook*.

Overview

A bank's installment lending portfolio is usually comprised of secured or unsecured small loans, each scheduled to be repaid in equal installments at fixed intervals over a specific period (closed-end loans). Installment loans are made directly to customers for activities such as buying automobiles, boats, or recreational vehicles. Other installment loans are made indirectly, that is, customers purchase these types of items by accepting loans from third-party brokers or dealers. Although automobile leases are not the same as loans, the installment lending industry typically manages leases in the same manner as loans.

The vast majority of the installment lending industry is highly automated and technology-intensive. Banks' analytical and monitoring capabilities continually improve because of technological advances, allowing banks to better identify and differentiate risk and to accept increased credit risk on a calculated basis. Many banks rely on technology and their loan officers' experience to expand installment lending activities and target higher-risk loans.

Banks offer numerous installment lending products with term and pricing variations tailored to meet customer circumstances. Banks can be successful in the installment lending industry if they have a sound understanding of the markets they serve, well-developed risk management processes, efficient economies of scale, a board of directors-approved risk appetite, and strong customer relationships.

Because a well-managed installment lending portfolio can be lucrative for a bank and provide an avenue for cross-selling opportunities, competition can be fierce. The installment lending industry has expanded to include several nontraditional market participants, including investment brokerage firms and insurance companies. Market share lines have blurred among traditional niche players (banks, finance companies, captive finance companies, and credit unions) as they increasingly compete across markets. Moreover, larger

banks compete nationally and tend to view their markets regionally. Technological advances, including Web-based solutions, fuel expansion of product marketing and delivery channels.

Banks and other financial services providers continually broaden their strategic decisions for product offerings, such as automobile loans, particularly when they offer installment loans nationwide. The number of mergers and acquisitions between banks and other financial services providers is predicated, in part, on the need to achieve greater economies of scale to compete effectively and efficiently.

Direct Loans

Banks originate direct loans with customers without intervention from third-party brokers or dealers. Customers typically use direct loans to finance purchases of automobiles, boats, recreational vehicles, pools, or spas and to obtain small-dollar loans. The loans are typically written with monthly amortizations of various durations.

Bank branches and call centers generate the majority of the direct loan business, although online lending has gained prominence as a delivery channel. Underwriting may be automated or manual and often includes using credit scores and other rules-based criteria. Competition puts pressure on direct loan underwriting and frequently results in lower credit standards, competitive interest rates, increased advance rates, and extended repayment periods.

Indirect Loans

Customers apply for indirect loans with third-party dealers to finance customer purchases that typically include automobiles, boats, or recreational vehicles. Third-party dealers subsequently sell the indirect loans to banks with which the dealers have established relationships. Written agreements spell out the terms of the relationships between dealers and banks. Banks work with dealers that meet the banks' business criteria. Some banks work with dealers who are in their local or regional markets, while other banks work with dealers nationwide. Dealers generally have relationships with multiple banks to obtain the best possible rates for their customers' loan applications. Each bank competes for the dealers' indirect loans by providing optimal service including quick responses and favorable pricing.

Banks regularly provide updated rate sheets to their dealers. The rate sheets include the bank's buy rate (the interest rate the bank charges for the loan), the maximum customer rate (interest rate the dealer can charge the customer), and term limits based on the age of the collateral (new and used, model year). The rate sheets may also provide other information, such as down payment requirements. Rate sheets may be standardized or vary, for example, by geographic region, manufacturer, or dealer. In some cases, banks may run short-term "loan sales" to generate volume or diversify some aspect of the banks' loan portfolios. In the past, direct loans carried lower interest rates than indirect loans, but pricing differentials are no longer a significant consideration because of competition in the indirect market and the customer's desire for one-stop shopping (i.e., simultaneous purchase and financing).

Dealers routinely transmit completed loan applications to multiple banks simultaneously. Dealers typically accept loans from banks offering the fastest response or the best buy rates. Some dealers may direct portions of their business to certain banks for other reasons. For example, if a dealer knows that one bank will underwrite higher-risk applicants, the dealer may direct some of its lower-risk applicants to that lender even if the buy rate is not favorable.[1]

Once the dealer accepts a bank's loan, the dealer and customer complete the loan, title, and lien documents. The dealer forwards all documents, including the original loan application, to the bank. The bank disburses loan proceeds to the dealer after the bank verifies document accuracy. Quality control (QC) plays a key role throughout this process.

Indirect Leases

Customers originate indirect lease contracts through third parties, generally automobile dealers. Third-party dealers subsequently sell the indirect lease contracts to banks with which the dealers have prearranged master agreements governing the originating/purchasing relationship. Dealers routinely transmit completed lease applications to multiple banks simultaneously and sell leases to banks that offer the most profitable terms to the dealers.

Customers find indirect leases attractive because this option offers lower monthly payments than loans, and, in some cases, can offer tax advantages. Because of the volatility of this market and its complexities, large lenders dominate the market—primarily manufacturers' captive financing subsidiaries, large banks, and financial services providers. (**Note:** Refer to Accounting Standards Codification (ASC) 840, "Leases," for more information about various types of leases and accounting requirements.)

Manufactured Housing Loans

In 1980, Congress adopted the term "manufactured home" to describe a house constructed in a factory to comply with the 1976 building code developed by the U.S. Department of Housing and Urban Development (HUD). The building code also enhanced the design, safety, and quality of manufactured homes. While often referred to as mobile homes, more than 95 percent of all manufactured homes are permanently sited with their initial installation.

There are two types of manufactured homes: single-section homes with 780 to 1,200 square feet of living space and multi-section homes composed of two single units joined together with 1,050 to 2,000 square feet or more of living space. Qualifying mortgage loans eligible

[1] A small dealer may send the application information to the bank, but customers will have to go to the institution to complete the underwriting process and sign the paperwork (similar to a direct loan).

for 50 percent risk-weighting for risk-based capital, include manufactured homes titled as real property.[2]

Student Loans

Student loans have unique characteristics, notably that repayment typically is deferred until the borrower's education is completed. Refer to the "Student Lending" booklet of the *Comptroller's Handboo*k for more information.

Small Dollar Loans

Although the OCC encourages banks to respond to customers' small dollar needs, examiners should be aware that small dollar loans could expose banks to credit, reputation, operational, compliance,[3] and other risks. Banks that offer small dollar loans (typically $2,000 or less with terms up to 60 months) should do so in a safe and sound manner and not engage in practices that expose the banks to undue risk. If such loans are structured properly, including appropriate underwriting and credit administration policies and practices, they can provide a safe and affordable means for customers to transition from reliance on high-cost debt products.

Regulatory Considerations for FSAs

No aggregate exposure limit applies to a national bank's installment lending activities as long as the volume and nature of the lending does not pose unwarranted risk to the bank's financial condition. However, the Home Owners' Loan Act (HOLA) limits an FSA's investment in consumer loans to 35 percent of assets when aggregated with the FSA's commercial paper and corporate debt securities provided that the FSA may only invest in amounts in excess of 30 percent of assets in direct loans.[4]

For determining compliance with the lending and investment limitations under HOLA, an FSA does not have to aggregate its consumer loans with education loans,[5] home

[2] Refer to 12 CFR 3.32(g)(1), "Residential Mortgage Exposures." Manufactured homes may also be titled as personal property or chattel and thereby would not be eligible for the 50 percent risk-weight.

[3] Banks should refer to applicable regulations and guidance in the "Truth in Lending Act" booklet of the *Comptroller's Handbook*; OCC Bulletin 2013-40, "Deposit Advance Products: Final Supervisory Guidance"; and the U.S. Department of Defense's Military Lending Act Rule, 32 CFR 232, and 80 Fed. Reg. 43560, "Limitations on Terms of Consumer Credit Extended to Service Members and Dependents."

[4] Refer to 12 USC 1464(c)(2)(D), "Loans or Investments Limited to a Percentage of Assets or Capital."

[5] Refer to 12 USC 1464(c)(1)(U), "Educational Loans."

improvement loans (even when made without real estate security),[6] deposit account loans,[7] and credit card accounts.[8] HOLA provides a separate authority and investment limit for each of those loan types.

In addition, 12 CFR 160, "Lending and Investment," requires FSAs to conduct lending activities prudently and use lending standards that meet the following objectives:

- Safety and soundness.
- Adequate portfolio diversification.
- Appropriateness, considering the FSA's size and condition, nature and scope of its operations, and conditions in its lending market.

Fundamentals of Installment Lending

A bank's installment lending activities are primarily process-based, relying extensively on technology, automation, and ongoing innovation. Lenders often employ some level of credit-scoring[9] technology within their underwriting decision-making framework. Because lending operations tend to be highly automated, seemingly small decisions can quickly create big problems if not effectively monitored. Consequently, banks should manage their lending processes prudently and maintain the systems and controls necessary to effectively identify, measure, monitor, and control risk.

Risks Associated With Installment Lending

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank's current or projected financial condition[10] and resilience.[11] The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive. Any product or service may expose a bank to multiple risks. Risks may also be interdependent and may be positively or negatively correlated. Examiners should be aware of this interdependence and assess the effect in a consistent and inclusive manner. Examiners also should be alert to concentrations that can significantly elevate risk. Concentrations can accumulate within and across products, business lines, geographic areas, countries, and legal

[6] Refer to 12 USC 1464(c)(1)(J), "Home Improvement and Manufactured Home Loans."

[7] Refer to 12 USC 1464(c)(1)(A), "Account Loans."

[8] Refer to 12 USC 1464(c)(1)(T), "Credit Card Loans."

[9] Credit scorecards provide an objective, numerical measure of a borrower's credit risk based on statistical models that predict performance and the probability of default.

[10] Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

[11] Resilience recognizes the bank's ability to withstand periods of stress.

entities. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of banking risks and their definitions.

Although installment lending generally involves all of these risks, this booklet focuses on credit, operational, compliance, strategic, and reputation risk. For a more complete discussion of the other risks as they relate to lending, refer to the "Loan Portfolio Management" booklet and other retail credit and compliance-related booklets of the *Comptroller's Handbook*.

Credit Risk

As with other types of lending, credit risk is a significant risk inherent to installment lending. Credit risk is present in every part of the lending cycle: initial credit acquisition and underwriting, account management, and, when applicable, collection. Additionally, this risk increases as banks lend to borrowers who demonstrate potential for higher default risk.

Concentration risk is one type of credit risk of particular concern to installment lending managers. This risk involves lending activities concentrated in a given product, nonstandard product types, or higher-risk borrower profiles, as well as loans centered in geographic areas, to borrowers with common employers, etc.

Because installment lending, much like other retail credit operations, typically consists of a relatively large number of homogeneous loans, credit risk is generally evaluated and managed on a portfolio or pooled basis.

Operational Risk

The quantity of operational risk exposure increases in relation to a bank's volume of installment lending transactions. Risk increases depending on the loan sourcing venues used, product variations, and level of automation used to run the installment lending activities. Operational risks in installment lending that should be controlled include marketing, loan acquisition or origination, account management, documentation or record-keeping management, payments processing, and management of collection activities. Any functions of successful installment lending activities may be performed internally or by a third party. If a bank uses third-party vendors, the bank should ensure that these relationships are effectively managed. During financial crises, banks may suffer significant operational problems or losses when high volumes of delinquent installment loans overwhelm servicing systems or when third-party vendors fail to meet contractual obligations.

Compliance Risk

Installment lending is highly vulnerable to compliance risk given the number of applicable consumer protection laws and regulations, which include the Truth in Lending Act, implemented by Regulation Z; the Servicemembers Civil Relief Act; the Military Lending Act; and the Equal Credit Opportunity Act. Consumer protections laws and regulations require fair and equitable treatment of credit applicants. Banks should ensure appropriate policies and processes to manage compliance risk throughout the entire installment loan life

cycle. (For more information about consumer protection laws and regulations, refer to the *Consumer Compliance* series of booklets of the *Comptroller's Handbook.*)

Strategic Risk

Management should understand the installment lending industry's market conditions, economic dynamics, and customer behavior. A bank's decision to enter, exit, or otherwise change its participation in the market should be based on sound and complete information, as well as realistic assessments of the risk involved, management expertise, operating capacity, and resources to support the activity. Without robust evaluation of these areas, the bank will be exposed to unnecessary and unanticipated strategic risk, which often translates into financial losses.

Reputation Risk

Inadequate policies and procedures, operational breakdowns, or general weaknesses in any aspect of a bank's installment lending activities can harm the bank's reputation. Reputation risks can include the perception that a bank (or a third-party vendor) is engaged in discriminatory, predatory, unfair, deceptive, or abusive practices, or has otherwise failed to comply with applicable customer laws and regulations. Additionally, high levels of past-dues, foreclosures, and losses can affect the bank's reputation because these statistics are tracked by bank analysts and communicated to investors, depositors, and others.

To assess reputation risk, examiners consider

- volume and number of installment loans under management or administration.
- merger and acquisition plans and opportunities.
- potential or planned entrance into new installment loan products, marketing strategies, or technologies (including new delivery channels).
- the market's or public's perception of the bank's financial stability.
- past performance in offering new products and services and in conducting due diligence.
- ability to minimize exposure from violations of laws and regulations, and from customer complaints.
- management's willingness and ability to adjust strategies based on regulatory changes, market disruptions, and market or public perception.
- quality and integrity of management information systems (MIS) and the development of expanded or newly integrated systems.
- exits from existing loan products.

Risk Management

Each bank should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the size and complexity of its operations. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems. Refer to the "Bank Supervision

Process" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

In installment lending, risk management generally describes a specific function responsible for ensuring that product and program initiatives stay within the risk appetite approved by the board.

Risk management may be centralized or decentralized, depending on the size and complexity of the bank's lending activities. For example, in many community banks, risk management processes may be spread among a number of individuals who perform this function in addition to their primary roles as loan officer, auditor, cashier, etc. In fact, management may not even use the term "risk management" to describe this function if the function is not formalized. On the other hand, large banks may have dedicated risk management units to monitor major installment lending products.

Examiners should ensure that banks perform the necessary responsibilities and that the persons responsible for performing the functions have the necessary expertise, independence, and management oversight. All three components are critical, because effective risk management involves reliable, objective, and thorough analyses of performance and the authority to respond to identified issues.

Risk management processes typically include the following:

- Managing the quantity of credit risk given the approved risk appetite and desired returns.
- Establishing prudent credit standards and practices including portfolio diversification and internal limits for concentrations of credit.
- Identifying the need for policy revisions through a process of ongoing analysis and evaluation.
- Ensuring that any departures from established parameters are promptly identified, explained, reported, and resolved.
- Monitoring portfolio quality and analyzing performance.
- Identifying the root causes of adverse performance results or trends with respect to product projections, unit forecasts, and past performance.
- Managing and maintaining scoring models and, sometimes, developing credit models.
- Managing and maintaining current and delinquent account management strategies.
- Analyzing the impact of actions taken (or proposed) with respect to product design, underwriting, target markets, and account management practices and strategies.
- Reporting findings and remedial actions to senior management and the board.
- Ensuring that the installment loan product life cycle does not result in discrimination on a prohibited basis and that the bank maintains compliance with all applicable laws, regulations, and rules.

The bank's risk management process is responsible for promoting the early and accurate identification of existing and potential problems, i.e., guarding against the development of risk levels outside of the board's risk appetite. This is accomplished by performing analyses throughout the product and account life cycles and using that information as a basis for

management decisions regarding underwriting, marketing, and portfolio management (account management and collection). This is a continual process. As market conditions, products, customer behavior, laws or regulations, or the bank's strategy or objectives change, account acquisition and management practices should be reevaluated and modified as warranted. In larger or more complex banks, the risk function may also conduct independent transactional testing to ensure that the line of business adheres to underwriting criteria and collections policy and is consistent with regulatory guidance such as OCC Bulletin 2000-20, "Uniform Retail Credit Classification and Account Management Policy: Policy Implementation."

Risk management relies heavily on accurate, timely, and comprehensive MIS and reporting. Risk management also involves support from the other control systems that measure conformance with established standards. Through operational reviews, these controls provide assurances that risk is confined to the desired levels and that any outliers are promptly identified and resolved.

For more information, refer to the "Retail Credit Risk Management" booklet of the *Comptroller's Handbook.*

Management

All banks should implement sound, fundamental business principles that identify risk, establish controls, ensure compliance with applicable laws, regulations, and internal policies, and provide for monitoring systems for lending activities. Monitoring systems should also provide a mechanism to identify, investigate, and report suspicious activities. Because installment lending includes numerous activities that pose significant risks, the bank should have effective policies and strong internal controls governing each operational area. Effective policies and internal controls enable the bank to adhere to its established strategic objectives and to institutionalize effective risk management processes. Policies also can help formalize the bank's

- risk appetite.
- risk culture.
- practices across lines of business.
- standard operating procedures.

The installment lending process has become more automated and sophisticated, and the nature of the products varies widely. Given these trends, a bank's installment lending activities should have the management and organizational structure, expertise, staffing levels, information systems, training programs, internal controls, and loan review processes to operate effectively.

A bank's installment lending strategy should include pro forma depictions of the expected portfolio mix by product or credit score and the expected performance by delinquency and losses. Internal reports should monitor portfolio performance according to the expectations set forth in the strategy and the pro forma expectations. Appropriate management or the

board should highlight and discuss significant deviations from expectations. Examiners should assess the adequacy of the strategy and the strategic planning process in relation to management's ability to achieve the desired outcomes.

Regardless of a bank's size and the scope and nature of installment lending activities, the strategy should clearly articulate the level of risk the bank's board wants to accept and generate within its book of business. The strategy should reflect the board's risk appetite and realistic objectives based on reasonable data and assumptions. The objectives should include the type of programs and products offered for all installment loans. For each major program and product, management should fully understand the

- interest rates, terms, and conditions.
- channels through which the products are offered (retail branches or wholesale relationships).
- expected cash flow repayment ability.
- expected collateral coverage margins.
- management's objectives, such as profitability, portfolio composition, volumes by product, credit score, and loan-to-value (LTV) ratios.
- liquidity, regulatory capital, and allowance for loan-loss considerations that must be met.

The board's risk appetite should balance underwriting standards with a reasonable pricing structure to achieve the desired portfolio mix and return.

Underwriting, Credit Scoring/Modeling, and Product Marketing

Management implements the board's strategic plan and stated appetite for installment lending risk through loan underwriting, credit scoring/modeling, and product marketing. Management's plans should describe the acquisition process by defining the product, specifying the target market, and translating growth objectives into a detailed marketing plan. In addition to describing the product itself, the product definition should include underwriting standards designed to accomplish the stated risk objectives. The process typically includes heavy involvement from

- risk management or policy, to develop underwriting standards and monitor the need for modification.
- credit scoring/modeling.
- marketing, to execute marketing and advertising plans.

The various control functions (loan review, QC, compliance, audit, and, if outsourcing is involved, third-party management) are also active in this process.

Underwriting

Prudent underwriting is of paramount importance to effective lending. Over the years, the basic components of effective lending decisions have come to be known as the "five Cs" of credit: character, capacity, capital, collateral, and conditions.

- **Character** refers to a borrower's reputation.
- **Capacity** measures a borrower's ability to repay a loan by comparing income against recurring debts.
- **Capital** is the net worth the borrower puts toward a potential investment.
- **Collateral**, such as property or large assets, helps secure the loan.
- **Conditions** are outside circumstances that may affect the borrower's financial situation and ability to repay; for example, what is happening in the borrower's industry, the local market, and competition.

Sound installment loan underwriting recognizes and incorporates these important components to the extent possible.

Specific underwriting criteria vary based on the level of risk the bank is willing to accept. The criteria are designed to measure a customer's financial capacity, in terms of disposable income available for orderly debt repayment and willingness to repay, typically with heavy reliance on past performance on financial obligations. Underwriting criteria should include guidelines for acceptable credit quality, generally including debt or income ratios,[12] credit scores when used, LTV ratios or advance rates, maximum loan duration, and pricing.

For installment lending activities, the bank may consider the value of collateral, such as for automobile loans, when establishing underwriting standards. The premise is that the bank can accept a higher level of risk from an individual creditworthiness perspective because of the protection against loss provided by the collateral. Although the collateral may mitigate a credit's risk of loss, underwriting criteria should always focus on an income stream rather than collateral liquidation for repayment. Further, the loan's term should consider the useful life of the collateral. Examiners may criticize lending practices that allow for extended loan terms without effective risk management processes.

Pricing is a key component of underwriting. While striving to adopt risk-based pricing, the bank should achieve a balance between pricing for risk and creating risk through pricing. Pricing errors can jeopardize portfolio performance and ultimately affect profitability. Indications of potential problems include pricing above or significantly below the market. If the bank prices above the market for a given risk profile, the bank may experience the following:

- Lower than anticipated response rates, which translate into higher acquisition costs per account and less ongoing product revenue. The question then becomes whether revenue is sufficient to support the associated infrastructure and what the implications are for capital.

[12] Refer to OCC Bulletin 2013-40, "Deposit Advance Products: Final Supervisory Guidance." The guidance states that an OCC-supervised bank is expected to assess the customer's ability to repay a loan while allowing the customer to continue to meet typical recurring and other necessary expenses such as food, housing, transportation, and health care, as well as other outstanding debt obligations. Refer to OCC Bulletin 2015-36, "Tax Refund-Related Products: Risk Management Guidance."

- Adverse selection, because lower-risk customers take advantage of other less costly financing options available to them. The highest-risk customers apply for and accept retail credit at almost any rate.
- Heavier than anticipated prepayment or attrition rates. Attrition refers to customers who voluntarily close their accounts. If pricing or other terms are viewed as onerous, borrowers may choose to pay off their loans as soon as possible or refinance them at financial institutions with more favorable terms. This may be mitigated, to some degree, by the imposition of prepayment fees. Prepayment fees, however, may create ill will that affects the bank's ability to develop a long-term banking relationship with the customer.

Some banks opt to price significantly below the market to achieve growth objectives. This too may have unintended consequences. Below-market pricing is particularly dangerous when underwriting, is lax, or favorable pricing is offered across the board. Forecasts for such pricing should include realistic assumptions for the level of risk being assumed. Forecasts should stratify the expected income and anticipated loss rates by credit grade or score so that cutoffs are established to promote profitable performance. Potential negative ramifications include the following:

- Higher than anticipated response rates overwhelming the bank's capacity to make decisions and service the accounts. Beyond the potential for loss of business and significant operational issues, this may also result in violations of law, for example, with respect to adverse action notifications.
- Inability to achieve or sustain profitability. In general, market rate pricing assumes a certain level of costs and a reasonable return. Therefore, pricing below the market leaves a bank with less room for error. If the response rates significantly exceed expectations, resulting in higher funding and operational costs, or performance falls below projections, resulting in higher collection expenses and credit losses, profitability is clearly jeopardized.

Banks' forecasts should include realistic assumptions regarding the level of account retention and the ultimate impact on profitability. Most introductory pricing strategies are loss leaders—banks cannot achieve or sustain profitability at those rates. Bank strategies should be well targeted, with carefully constructed underwriting parameters, to avoid "adverse retention," (i.e., a portfolio that consists of high-risk borrowers locked into unrealistically low interest rates in terms of the credit risk posed).

Credit Scoring/Modeling

Most banks use modeling to some degree in installment lending activities. Credit scoring is used to control risk in acquisition and underwriting, account management, and collection processes. Scoring is a very technical area with its own set of advantages and pitfalls. Banks should have a basic understanding of this area before examining the installment lending process. OCC Bulletins 1997-24, "Credit Scoring Models: Examination Guidance," and 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance," provide additional guidance concerning credit scoring and other models.

Credit scorecards, one form of a credit model, are risk-ranking tools that attempt to predict which accounts will exhibit "good" payment behavior and which will not. (The definition of the "bad" accounts varies but typically involves some level of delinquency, usually 60 or 90 days past due.) The scores generated indicate the relative level of risk in either ascending or descending order, depending on the convention the developer uses.

Scoring employs mathematical techniques to predict borrower behavior based on past performance. Predictive horizons range from six months to two years. The assumption is that the behaviors of the scored population going forward will not change markedly from those of the population used to develop the model. The ability of models to differentiate risk should be routinely monitored because model performance deteriorates with time due to shifts in customer behavior, economic conditions, and bank and industry product terms and marketing.

The majority of scoring models rely on statistical regression techniques (linear, logistic, or neural network), but banks occasionally use non-empirical "expert" models. Expert models are designed using subjective and judgmental factors; usage is limited, however, because Regulation B (which implements the Equal Credit Opportunity Act of 1974) requires scorecards that use an applicant's age as a factor in credit decisions to be empirically derived and demonstrably and statistically sound.[13]

Models are categorized as generic (off-the-shelf) or custom. Generic scorecards are also known as pooled data models, because the developer uses information obtained from multiple lenders or credit repositories or bureaus to create the model. Generic scorecards are most often used when the bank lacks a sufficient number of approved and denied applications or depth of account history to provide the requisite development sample (i.e., the bank does not have enough data to generate statistically valid conclusions) to build a custom scorecard.

Proprietary or custom scorecards are bank- or product-specific models developed using the bank's own data and customer experience. These scorecards may be developed in-house if the bank has the modeling expertise on staff, or scorecards may be developed by modeling vendors. All model components, including input, processing, and reporting, should be subject to validation; this applies equally to models developed in-house and to those purchased from or developed by vendors or consultants.

Scoring systems do not normally consist of a single model. Recognizing that there are differences in available information and behavior patterns, the modeler attempts to segment the test group into similarly situated subpopulations. The modeler can then develop individual scorecards for each distinct subpopulation that use the variables most predictive of risk for that particular test group, thereby increasing accuracy and precision. For example, an installment loan application might consist of seven models: a "thin file" scorecard for applicants with little or no previous credit history; three "derogatory" or "subprime" models for those with prior delinquencies; and three "prime" scorecards for those with more substantial credit histories who have been paying on time. The definition of the

[13] Refer to 12 CFR 1002.6(b)(2), "Age, Receipt of Public Assistance."

subpopulations and the determination of how many to use are key components of the model development process.

Banks' use of risk models in the underwriting process varies. Banks may

- use scoring models exclusively to approve or reject loan applications.
- rely heavily on scoring, using automated underwriting systems to approve high scores and reject low scores, but divert borderline scores to underwriters for further review ("gray zone" strategies).
- use scores as one among many inputs in a judgmental underwriting process.
- use scores to route applications between senior and junior underwriters or for some other queuing strategy.

Most large retail credit operations fall into the second category above, while smaller banks with low volume tend to fall into the third category. The types of scores generated by risk models include the following.

- **Credit bureau risk scores:** The most widely used of all the scores, bureau scores use only information on file at the three major credit bureaus; loan-specific information and general economic conditions are not included in these models. Although the models that each bureau uses are somewhat different, they all consist of the same number of sub-scorecards and assign a three-digit number ranging from 300 to 850 (bureaus may adjust the range from time to time). The scores quantify the relative ranking of consumers according to general credit quality. The higher the consumer score, the lower the credit risk. Each bureau has a name for its own scoring system: Beacon at Equifax, Empirica at TransUnion, and Experian at Experian. In March 2006, the three bureaus launched a new scoring model called VantageScore to compete with FICO in selling scorecards to banks. For the most part, vendors developed credit bureau scorecards (e.g., FICO, VantageScore, and Experian ScoreZ), although a few large banks have collected enough data over time to develop their own internal scores.

  Credit bureau scores consider five general groups of predictive variables:

  – Previous performance, including recency, severity, and frequency of poor performance.
  – Current level and use of nonmortgage debt.
  – Amount of time that credit has been in use.
  – Pursuit of new credit and inquiries.[14]
  – Types of credit available.

- **Application scores:** Application scores incorporate information from loan applications as well as various credit bureau data, possibly including the bureau scores. In some cases,

[14] Multiple inquiries in a short period of time are usually eliminated, or "de-duped," so that the consumer is not penalized for rate shopping. In addition, non-consumer-originated promotional inquiries are excluded.

the models may also consider information related to the transaction being financed. The scores may be used to determine pricing as well as to decide loan approval or denial.

Once the accounts are booked, banks often use additional models to help manage the portfolios. Scores are used to monitor portfolio risk, implement account management initiatives, target cross-selling opportunities, prioritize collection activities, and additional purposes. These scores may include the following:

- **Behavioral scores:** These models generate scores based on customer performance on the bank's loans (e.g., payment and delinquency patterns). Whereas traditional behavioral scorecards were confined to internal or "on us" borrower performance, many models now include bureau scores or certain bureau report characteristics in the scores. Some collections departments use specialized behavioral models based on the performance of delinquent borrowers to focus collection efforts on higher-risk borrowers.
- **Bankruptcy scores:** These are designed to identify customers posing a higher risk of bankruptcy based on the attributes of customers who have declared bankruptcy. Bankruptcy scores usually are used in conjunction with conventional credit risk models.

Banks may also use non-credit-risk models in the account acquisition, underwriting, and account management processes. These models include the following:

- **Marketing:** Target marketing initiatives to meet preferences or perceived needs.
- **Response:** Target prospects most likely to respond to an offer.
- **Revenue:** Project the level of revenue a customer will generate.
- **Attrition:** Identify accounts likely to prepay or voluntarily close.
- **Fraud:** Identify potentially fraudulent applications.

Bankers sometimes combine multiple scorecards. This practice is also known as model layering or matrixing, through which the bank benefits from combining the risk selection capabilities of the various models used. Matrixing lets the bank adjust the cutoff on a cell-by-cell, stair-step basis, allowing for "swap sets." This enables the bank to approve the best of the customers, who may or may not have been approved based on a fixed cutoff score. For effective use of matrixing, the bank should develop a "joint delinquency" table (which can be converted to a "joint odds" table) from the combination of multiple scorecards.

The "swap set" concept is illustrated in table 1, in which the application scores are on the vertical axis and the bureau scores are on the horizontal axis, with the risk decreasing as scores increase. The percentages in the body of the table represent the frequency with which an account was ever delinquent within a defined time period.

Table 1: Joint Delinquency Matrix, Delinquency Rates

	Less than 600	600–649	650–699	700–749	750 or higher	Average delinquency rate by custom score segment
Less than 180	20%	14%	14%	11%	8%	13.4%
180–199	13%	11%	10%	6%	7%	9.4%
200–219	11%	10%	7%	5%	5%	7.6%
220–239	10%	7%	5%	4%	5%	6.2%
240 or higher	8%	3%	3%	2%	1%	3.4%
Average delinquency rate by bureau score segment	12.4%	9.0%	7.8%	5.6%	5.2%	

Assume, for simplicity, that the delinquency chart is based on the performance of 2,500 borrowers evenly distributed over the 25 cells (i.e., 100 borrowers in each cell).

If the bank's tolerance for risk is associated with a delinquency rate of roughly 6 percent, a custom scorecard cutoff of 200 would result in a 5.7 percent average delinquency rate (e.g., the combination of 7.6 percent, 6.2 percent, and 3.4 percent would average 5.7 percent). The bank could lower the average delinquency rate to 5.1 percent—an 11.6 percent reduction in the delinquency rate—without decreasing volume by overlaying the bureau score and swapping out poor performers (i.e., bureau scores below 650) with custom scores greater than 200 and swapping in better performers (i.e., bureau scores greater than 700) with custom scores less than 200.

Banks also layer credit scores with nonrisk scores (e.g., risk, revenue, and response models may be used together). This practice presents difficulty in that the purposes of the models used may conflict. Although management tries to control credit risk by using the risk score, revenue and response scores generally increase for higher-risk borrowers (reflecting higher potential for revenue generation in terms of pricing and fees and greater propensity to respond to credit offers). This may result in adverse selection (e.g., higher-risk borrowers are more likely to respond). The odds associated with the risk score can be adversely affected as fewer "good risk" prospects respond relative to the level of "bad risk" prospects. Management's planning should reflect a solid understanding of the risks associated with the use of these types of strategies.

Model Documentation

Bank policy should address maintaining model documentation as follows:

- **Model inventory:** Summary listing of all models in use, their application(s), and the dates developed, implemented, and last validated.
- **Individual models:** Model documentation that is understandable and sufficiently detailed to allow for precise replication should the need arise.

- **Chronology log:** Listing by date of all significant internal and external events relevant to the credit function (score implementation, product changes, cutoff score changes, major marketing initiatives, economic or competitive shifts, etc.).

Comprehensive manuals describing development and ongoing maintenance and validation requirements should accompany models purchased from vendors.

Model Management and Tracking

Banks using scoring systems should have the management expertise and processes to evaluate the models, ensure their appropriate use, monitor and assess their performance on an ongoing basis, and ensure proper validation. This oversight also extends to any scoring-based strategies employed. OCC Bulletin 1997-24, "Credit Scoring Models: Examination Guidance," and OCC Bulletin 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance," provide guidance for scorecard management.

A scoring override occurs when a credit decision is made that contradicts the decision indicated by the customer score. High-side overrides are requests that meet or exceed the score cutoff but are denied (which can occur when the bank considers variables or characteristics that were excluded from the model), while low-side overrides fail the cutoff but are approved. Not only are these policy exceptions, but excessive levels of overrides diminish the effectiveness of the scoring models and may indicate illegal discrimination (prohibited by Regulation B, which implements the Equal Credit Opportunity Act).[15] Furthermore, approved loans that fail to meet the score cutoff often perform worse than loans above the cutoff. Bank management should evaluate low-side overrides by comparing them with the bad rate[16] at the lowest score band above the cutoff; the highest-scoring overrides just under the cutoff should theoretically outperform the marginal passes in the next-highest score band.

Override tracking is an important control. Bank management should track override performance by reason, channel, analyst, and score band, and monitor the volume, reason codes, and quality of the override segment. Banks should know why some applicants with low scores are approved and others with high scores are denied. Override volume and quality may support the need for underwriting criteria or score cutoff changes. Table 2 shows an example of override tracking.

[15] The prohibited bases are race, color, religion, national origin, sex, marital status, age, the fact that all or a part of the applicant's income derives from any public assistance program, or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law on which an exemption has been granted by the Consumer Financial Protection Bureau (12 CFR 1002.2(z), "Prohibited Basis").

[16] Typically default rate.

Table 2: Example of Override Tracking

Scorecard Overrides						
Score range	**Number approved**	**Percentage approved**	**Number denied**	**Percentage denied**	**Percentage of bad loans (volume)**	**Percentage of bad loans (dollars)**
800 or higher	50	100%	0	0%	1%	1%
750–799	100	95%	5	5%	1%	2%
700–749	200	93%	15	7%	2%	4%
675–699	300	88%	40	12%	3%	6%
650–674	400	89%	50	11%	5%	9%
625–649	60	15%	350	85%	8%	15%
600–624	10	9%	100	91%	11%	20%
Less than 600	2	4%	50	96%	100%	100%

Bank management should track low-side overrides by number as well as by dollar balances. Generally, banks establish low-side and high-side override limits.

Scorecard-tracking MIS is crucial for effective scorecard management and provides valuable information for risk management and marketing. Bank management generally monitors model performance to determine how much the bank's customer population has changed, to analyze and adjust cutoffs, and to determine when it is time to redevelop a model. Reporting frequency varies from monthly to quarterly, depending on volume and the level of risk involved.

There are two broad categories of scorecard MIS: front-end population stability reports (front-end or stability reports) and back-end performance reports (back-end reports). Front-end or stability reports measure score distribution changes in the customer and essentially determine whether the customer population is changing. This is important because if the population changes significantly, the change triggers the need for additional model analysis and possibly model adjustment (e.g., recalibration, alignment, or weighting) or redevelopment. Key front-end modeling reports typically include the following:

- **Application distribution reports:** Track approvals and denials and high- and low-side overrides by score band, provide feedback on application volumes and the success of marketing programs, and serve as an early warning of shifts in the risk profile.
- **Population stability reports:** Identify changes in the population by comparing score distributions of the developmental sample with current production.
- **Characteristic analysis reports:** Compare base with actual results for individual attributes when population stability changes. Bank management should track every attribute individually. Vendors often provide developmental sample population factors in scorecard manuals. If not, banks can form a benchmark population from the first use and track population stability over time.
- **Scoring accuracy reports:** Present the volume of scoring errors sorted by those deemed significant and those deemed minor. Significant errors represent miscalculated scores resulting in decisions inconsistent with the cutoff; minor errors are mistakes that would not alter the credit decision.

Back-end quality reports compare actual versus expected results and essentially determine whether scorecards still differentiate risk sufficiently. Back-end reports serve the dual purpose of measuring model efficacy and evaluating overall portfolio quality. Key back-end reports typically include the following:

- **Vintage tables and charts:** Measure the performance and trends of accounts originated each month or quarter. These are the most fundamental and indispensable model and portfolio management tools.
- **Delinquency distributions reports (DDR):** Compare scores with subsequent performance and show whether scorecards continue to rank order risk. DDRs present coincident delinquencies, which are actual delinquencies at a point in time.
- **Maximum delinquency distributions reports (MDDR):** Identical to DDRs, except MDDRs show "ever delinquent" statistics, which include delinquent loans that were cured, repaid, or charged off. Delinquencies are presented using the same definition of "bad rate" used in the model development.
- **Benchmarking:** Benchmark the post-implementation vintage tables or charts and delinquency distributions against the performance distributions generated from the developmental sample to determine whether the models are performing as expected. The distributions and tables based on the developmental data should reflect the bank's best guess of expected outcomes. Moreover, trends in the benchmarking analysis would be evaluated to differentiate between random but temporary deviations in performance (which may require minor changes in strategies) from permanent systematic deviations (which would require recalibration or redevelopment of the models).
- **Chronology logs:** Identify internal and external changes expected to affect model performance and the credit function so that a model can be properly evaluated in the future. For example, a chronology log records important external macroeconomic indicators, such as recession or changes in the unemployment rate, and internal changes such as changes in cutoffs, collection strategies, or override policies.
- **Early warning analysis:** Uses benchmark performance over shorter time horizons than the analysis used in the development of the model. While the performance window from many scoring models is 24 to 36 months, waiting up to three years to generate a valid back-end analysis is unsafe and unsound. For that reason, early warning performance benchmarks based on the performance of the model development sample over shorter performance horizons (e.g., 12, 15, and 18 months) should be constructed and used to project the performance of the current portfolio over the next 24 to 36 months.

Scorecard tracking reports should be designed to be comprehensive and consistent with the purpose of the model and should use a level of rigor reflecting the importance of the model in the decision process. Statistically valid tests should be used in lieu of judgment-based evaluation of charts.

Vendors and credit repositories periodically publish scorecard odds for generic models. Although the data are informative and sometimes useful when implementing a new model, the data are often outdated and differ significantly from individual bank results. Such pooled-data odds should not be considered an appropriate substitute for basic scorecard tracking by banks that depend on the models. Banks should perform formal revalidations using a discrete

sample of applications and regularly compute model separation measurements (Kolmogorov-Smirnov scores, chi-squared test, etc.).

Bank management should understand

- which models are deployed.
- how they are used.
- the control systems to manage and monitor model performance.
- how cutoffs and strategies are developed.
- how risk/reward trade-offs are made.
- how bank management analyzes portfolio and vintage performance and uses that information to alter or improve targeting, underwriting criteria, cutoffs, and other scoring strategies.

In short, bank management should determine whether the bank's models and related risk management processes effectively assess whether risk remains within approved tolerances.

Marketing of Products

Market channels are the various paths for acquiring or sourcing new customers or loan applications. Although channels indicate the type of acquisition process, marketing also includes identifying or prescreening applicants and the different levels of data submission required on the applicant's part. As with other variables, the type of marketing used may result in different levels of credit risk.

The populations targeted by the bank for a given product or marketing initiative affects the level of credit risk accepted. The bank's own customers typically represent less risk than nonbank customers, with risk increasing as the bank moves out of geographic areas where it maintains a presence. Over time, customer behavior usually demonstrates some degree of loyalty when there is an established banking relationship.

The bank also targets populations based on the level of credit risk presented and potential profitability. The bank may target prime or subprime customers,[17] or some combination thereof, recognizing that there are many stratifications of risk within those broad categories. For example, subprime borrowers with poor credit records who are trying to reestablish credit may represent a higher level of risk than those with little credit history who are trying to establish credit for the first time. The data available to analyze these two groups also differs, as does the manner in which the data are used to predict future repayment performance. Consequently, the bank's underwriting guidelines and operational processes should be structured to recognize and accommodate these differences.

The term subprime refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and

[17] Borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.

possibly more severe problems such as charge-offs, judgments, and bankruptcies. Subprime borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally, subprime borrowers display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months.
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months.
- Bankruptcy in the last seven to 10 years.
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood.
- Debt-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market- or institution-specific subprime definitions, but should be viewed as a starting point from which the OCC expands examination efforts.

The least risky acquisition process is submitting a full application to a bank loan officer. The loan officer has the benefit of a more fulsome summary of the applicant's financial condition as well as the opportunity for face-to-face interaction. As the channels become further removed from any type of relationship, the level of risk tends to increase.

Banks generally use the following types of application channels in installment lending:

- **Take-one applications:** Applications made available in public places, including bank branches, which any customer may complete and submit. Because these applications are unsolicited, they typically request comprehensive information.
- **Dealers:** The use of third-party vendors who generate loan applications to facilitate the sale of their products—generally automobiles, boats, recreational vehicles, appliances, furniture, pools, or spas. Dealers often maintain relationships with several banks to ensure that they can obtain, among other things: favorable pricing, diversification of financing sources, and funding for even the least creditworthy customers. The package submitted by the dealer to the bank includes information on the retail purchase transaction. Often the borrower financial information collected is limited, and the bank may need to supplement it. Dealer compensation varies based on the bank's agreement with the individual dealer and the terms of the individual loan. Agreements between banks and dealers should include quality and volume expectations, target acceptance rates, and compensation parameters. Compensation arrangements between banks and dealers, including any discretion dealers may have in setting loan pricing, should be

clearly outlined in the agreements and carefully structured so as not to result in discrimination on a prohibited basis (under the Equal Credit Opportunity Act and Regulation B).[18]

- **Internet:** The use of a bank-controlled Web site or participation with a Web-based loan broker to generate online applications. These applications may be bank-specific, or may be forwarded to a number of lenders in a broker-type situation. The extent of the information required by the bank varies based on the product involved and the vendor, and may result in a subsequent request for more information once the customer has expressed interest in a product or group of products. Online data security is imperative for this channel. Fees for broker-originated applications or expressions of interest vary depending on the bank's relationship with the broker.
- **Event marketing:** Participation in various events unrelated to the bank (although the bank may serve as a sponsor) to distribute loan applications to event participants. The most common venues for banks to engage in event marketing are trade shows (such as home and auto shows).
- **Direct mail:** A wide variety of marketing materials, including brochures, catalogs, postcards, newsletters, and sales letters. Direct-mail advertising is an effective and an often profitable way to reach out to new and existing clients.

Loans sourced in some of the above ways eliminate certain overhead expenses but increase the bank's need to perform strong quality assurance (QA) and vendor management functions. Refer to the "Third-Party Management" section of this booklet for more information.

The bank may also grow its installment loan portfolio through portfolio acquisition, i.e., purchasing an entire installment loan portfolio, or any segment thereof, from another financial services provider. The bank should evaluate loan quality and performance on a portfolio basis rather than a loan-by-loan basis. Comprehensive and effective due diligence is critical to ensuring that the bank understands the level of risk it would assume and that it prices its offer accordingly.

As banks expand into new channels, management should assess whether the bank has the systems to monitor the performance of those channels. A lack of experience and the failure to implement a strong control environment can lead to problems, including unexpectedly high application volumes, compliance issues, application fraud, and a host of additional situations not contemplated in the planning process.

Exception Reporting

A bank's underwriting policy and criteria reflect the board's risk appetite. Consequently, underwriting exceptions have the potential to change the risk profile of approved loans and the portfolio overall. The more the bank allows analyst judgment to affect the process, the higher the potential for exceptions from the bank's loan policy. Some level of exceptions is expected, since it is impossible to construct an underwriting policy that covers every possible scenario. Management should use the necessary MIS to identify and track exceptions, and

[18] Refer to 15 USC 1691 et seq, "Scope of Prohibition," and 12 CFR 1002, "Equal Credit Opportunity Act (Regulation B)."

ensure that the information is regularly analyzed to determine causes, impact, and, if warranted, the need for corrective action.

Exceptions typically fall into three categories:

- **Credit policy:** For example, to bank requirements regarding LTV, debt-to-income, pricing, verification, and geography.
- **Credit scoring:** Where applicable, high- and low-side overrides, as discussed previously.
- **Documentation:** For example, to bank requirements related to the loan application, deal/transaction information, insurance, or collateral perfection or valuation.

Banks should establish limitations for each type of exception, as well as a limit for aggregate exceptions, and monitor adherence to those limits.

Reports should track all exceptions to significant underwriting policy, scoring, and documentation requirements. Regarding credit in the scoring area, both high- and low-side overrides are considered exceptions. Not only can overrides result in changes to the portfolio's risk profile, an excessive level of credit scoring exceptions could invalidate the bank's stated scoring system.

MIS should include sufficient detail to facilitate management's meaningful analysis of exceptions overall and by type. The ultimate objective should be to determine whether the exceptions significantly affect the risk profile of the portfolio, positively or negatively. To make this determination, the assessment should consider the volume and trends of the exceptions and the ongoing performance of loans originated with exceptions. If performance on loans with exceptions is weaker than that of conforming loans, management should consider stricter adherence to policy.

Another benefit of exception tracking and analysis is the ability to drill down to the sources of those exceptions. By evaluating exceptions and subsequent performance by product, loan grade/credit quality, underwriter, manager, and channel (including individual dealer and branch), management can target corrective action to the source of the problem. For example, if one underwriter's exceptions are extremely high, it may be a training or performance issue for that individual. Or if a particular dealer consistently fails to deliver contracts that conform to the bank's underwriting requirements, and the loans subsequently perform poorly, it may warrant terminating the bank's relationship with that dealer. Operational issues, too, may surface as a result of these reviews.

The importance of comprehensive and accurate reporting and analysis of policy exceptions cannot be overemphasized. This is an essential risk management tool for monitoring and administering the underwriting/acquisition process.

Account Management

Account management is a term used to describe the loan administration portion of the installment lending process. Banks should fully test, analyze, and support their account

management practices, including credit line management and pricing criteria, for prudence before broad implementation of those practices. Account management encompasses the treatment of booked accounts.

As with acquisitions, account management includes heavy involvement from multiple units in the bank, including

- risk management or policy.
- marketing.
- operations, primarily customer service, retention, and payment processing.
- compliance, primarily debt collection practices, credit reporting practices, customer privacy, fair lending and fair treatment of borrowers.
- various control functions.

This section deals with activities affecting current accounts; the "Collections" section of this booklet discusses delinquent accounts.

Historically, "account management" was used in conjunction with open-end credit. Now, lenders making closed-end installment loans also are more actively managing their portfolios. The process begins with monitoring at the portfolio, portfolio segment (e.g., product, vintage, credit grade, or marketing channel), and account levels. Management relies on MIS and tools such as behavioral and credit bureau scoring to identify positive and negative trends such as improved portfolio quality or heightened delinquencies. Analyses of those trends and their root causes provide management with a basis for developing strategies to enhance performance and maximize profitability. These strategies often affect the bank's credit policy. Thus, management should develop the eligibility requirements and treatment characteristics for its strategies as carefully as it does the underwriting criteria for the bank's products.

Account management initiatives, such as marketing or retention strategies, can be deployed on an individual account basis or for entire portfolios or carefully selected segments thereof, and the strategies can be manual or automated. Regardless of the processes used, banks should develop and implement policies and procedures that adequately control and monitor the risk assumed and provide for consistent treatment of all customers. In most community banks, account management is frequently a manual process and conducted on an individual account basis. The larger the retail function or more complex the product, however, the more appropriate it is to have a more formalized account management process.

Although some banks use more of a one-size-fits-all approach to account management in which there is basically one option and the customer either meets the criteria or does not, other banks deliver a range of options based on each customer's individual creditworthiness and needs. The latter approach involves extensive use of technology and system support, but generally proves more profitable for the bank in the long run.

Just as with initial product design, management should test account management initiatives before full-scale implementation. Banks often use a "champion/challenger" testing technique,

in which the existing practice is deemed the "champion," and one or more modifications are applied to smaller portions of the portfolio as "challengers." After observing performance over a period of time, usually several months, a well-performing challenger may be applied to a larger population or may even replace the champion. Conversely, poorly performing strategies are either modified or discontinued. Ongoing and thorough analyses are critical to reaping the benefits of multiple strategy scenarios. For the analyses to be meaningful, the strategy populations should be isolated from other account management strategies. Otherwise, it may be impossible to determine factors contributing to the outcome with any degree of reliability.

Some of the more common account management activities employed in connection with installment lending include the following:

Cross-selling initiatives: Banks generally develop marketing strategies designed to target various components of their retail credit portfolios with additional loan or service offers. If developed properly, such marketing strategies often serve to reinforce the relationship with the customer. The bank should, however, assess whether cross-selling initiatives are fair and not deceptive, whether solicited customers have the financial ability to support the additional product or service, and that fee-based services add value. Otherwise, the bank may create customer ill will through inappropriate offers or unmanageable debt or payment burden.

Retention strategies: The competitive environment is rife with substitute offers and refinancing opportunities. Consequently, larger banks have found it beneficial to develop techniques for identifying profitable loan customers who may be targeted by competing offers, and to contact those customers to offer them more attractive or enhanced products—typically reduced interest rates or upgrades to associated products or services. Banks that do not actively contact customers may offer alternative products or refinancing to those customers who contact the bank seeking to close their accounts or requesting a loan payoff.

As with other account management activities, management should track the volume of the retention calls (in and out), the "save" rate, and the ongoing performance of those accounts. This information will help management assess the profitability of retention initiatives and make adjustments to policy.

Early loss mitigation (leasing): Unique to vehicle installment leases, early loss mitigation is also known as end-of-term remarketing and allows the bank to actively address leases nearing termination. Essentially, the bank seeks to maximize return and minimize losses by contacting customers up to 12 months before lease end to determine whether the customer plans to return or purchase the vehicle. Price negotiations begin at that time. Some banks establish the timing and frequency of their customer contacts based on the dollars at risk from a residual value standpoint, i.e., the greater the potential loss between the contract residual value and the estimated market value at the time of vehicle turn-in, the earlier the bank contacts the customer. Banks should employ reasonable valuation and pricing models (for lease-to-lease and lease-to-loan financing) in this process. Management should review the bank's overall exposure, resolution status, and other lease-end reporting performance

information to assess the adequacy of its loss mitigation efforts and the need for possible policy revisions (underwriting as well as remarketing).

Extensions and renewals: The bank's policies typically include guidelines for circumstances under which loans will be extended or renewed, as well as any fees involved. The policy for these activities should be reasonable in terms of frequency, duration, and creditworthiness requirements.[19] Generally, extensions should not be granted more frequently than once per year. Renewals, too, should be infrequent. Again, management should track the volumes involved and the subsequent performance of those loans.

Pay-aheads: These occur when a customer makes a payment that exceeds the minimum amount due and the bank keeps track of the excess payment and reduces future payments accordingly. Pay-aheads can pose increased risk, as they do not require a minimum payment every month. When banks require customers to make monthly payments, it enables the banks to monitor portfolio quality through more accurate delinquency reporting. Banks should limit the use of pay-aheads to accounts with low-risk characteristics.

Deferred payment programs: These involve the deferment of multiple payments and are generally unacceptable, because a key tenet of safe and sound installment lending is the expectation that the borrower will make a minimum monthly payment. Regular monthly payments add structure and discipline to the lending arrangement, provide regular and ongoing contact between the bank and the borrower, and allow the borrower to demonstrate and the bank to assess continued willingness and ability to repay the obligation over time. Conversely, the absence of a regular payment stream may result in protracted repayment, increased risk of default, mask true portfolio performance and quality, and make consistency with OCC Bulletin 2000-20 difficult to assess. Likewise, in connection with the bank's secured lending program, deferred payment programs may hamper collections or loss mitigation efforts.

Collections

The bank's collections function manages delinquent accounts. It is critical that the collection function promotes compliance with governing consumer compliance regulations. Further, the collection function should utilize experienced and skilled management and staff to effectively balance between minimizing losses through collecting past-due accounts effectively and preserving customer relationships to the extent possible. Orderly repayment is the goal, with repossession, foreclosure, or other legal actions the last resorts. Risk management and policy, systems, and the bank's various control functions provide significant support to its collection function.
The flow of accounts into collections is guided by policy that reflects the bank's credit culture. Specifically, the levels of past-due and charged-off accounts are largely affected by the

[19] OCC Bulletin 2000-20, "Uniform Retail Credit Classification and Account Management Policy: Policy Implementation."

- types of products offered, particularly secured versus unsecured.
- marketing channels/target markets, for example, bank customers and local residents as opposed to customers outside of the bank's locality.
- underwriting factors, such as advance rates, customer leverage ratios, and payment terms (loan amount, pricing, and duration).
- risk profile of the customer base, such as prime versus subprime accounts and associated penetration levels.
- manner in which the bank administers its loans (refer to the "Account Management" section of this booklet).
- economic conditions or changes in laws, regulations, and rules (e.g., bankruptcy reform or clarification of non-reaffirmed bankruptcy).

Management projects the collection unit's workload based on MIS reports of behaviors and trends for existing products, collection strategies, and other pertinent information. Roll-rate reports, which measure the movement of accounts from one payment status to another (current to past due, or vice versa, or from one delinquency bucket to another) are one of the most commonly used sources of information in this regard. Refer to appendix F, "Loss Forecasting Tools," of this booklet for more information on roll-rates and other methodologies.

Responsibility for collecting delinquent loans varies depending on the bank's approach to collections. In small community banks, the loan officer may be responsible for collecting his or her own loans. As installment lending activities increase in volume, and the need arises, banks tend to establish and use a separate collection unit. Many banks of all sizes now outsource some or all of their collection and recovery activities to third parties.

In addition to the structure used, banks vary their approaches to collection in terms of prioritization, work queues, and the form and frequency of customer contact. Banks generally prioritize accounts by level of delinquency, secured versus unsecured, dollars at risk, customer credit risk, or some combination thereof. Customer risk may be measured by an updated credit bureau score, which evaluates the customer's current credit condition, or by an internal behavior score, which assesses the customer's risk based on his or her past performance on the loan in question.

Banks that prioritize loans establish various work queues. How the queues are distributed to collectors depends on the bank's collection philosophy. Some banks establish queues based on the severity of loan delinquency. There are two distinct strategies: one is to assign the most experienced and effective collectors to the "back-end," or most severely delinquent accounts, and the other is to assign the most talented collectors to the "front-end," or early stage delinquencies, to prevent the accounts from rolling to more serious delinquency buckets. Although the former is most common, both strategies have merit. Alternatively, some banks adopt a "cradle-to-grave" approach, meaning that once an account has been assigned to a collector, it stays with that collector until it is resolved, whether the account is collected, liquidated, or charged off.

Collectors' tools include payment reminder calls (usually associated with subprime lending, the calls are made before the payment due date), statement notices, e-mail, texts, letters, telephone calls, and legal action. The bank's written policies and procedures and collection strategies govern what actions collectors take and at what point in the collection process those actions are taken. Settlements are a last-resort attempt to collect from a troubled borrower, and settlement terms should generally be no longer than 90 days.

In addition to describing the bank's approach to collection and recovery, the bank's policies and procedures should specifically address the following:

- **Authority levels:** Providing detailed guidance on collectors' latitude and limits with respect to making payment, forbearance, concession, or forgiveness arrangements with borrowers. The policy should also establish review and approval parameters, as well as reporting requirements.
- **Collector compensation:** Ensuring that in those cases in which there is some type of incentive pay, the collector compensation programs include requirements for compliance with policies, procedures, and laws, and that the programs are structured to include the number of accounts collected in addition to dollar volume.
- **Collector monitoring:** Providing guidance with respect to how collector performance is monitored and evaluated, specifically addressing call monitoring requirements.

Staffing plans should reflect the number of collectors necessary to handle the current and near-term projected collection flow, as well as needs related to current and anticipated expertise. In general, a more experienced and stable collections management and staff leads to a more effective collection effort. As experience levels decrease or turnover increases, overall productivity suffers, and severely understaffed units show disproportionately poor results.

Collector productivity is also linked to the quality of the training provided—initially and on an ongoing basis. Effective training includes classroom and on-the-job components, and generally focuses on building the collectors' negotiation skills and providing them a thorough understanding of the bank's policies and procedures and federal and state legal requirements related to collection efforts.

The use of technology has a direct impact on the efficiency and productivity of the collection unit and, hence, on staffing. Collection technology includes automated dialers that call a queue of customers a specified number of times a day or week until contact is made. When a call is answered, it is transferred to a collector, and the system automatically opens the customer's screen on the collector's computer. Call optimization software "remembers" the best time to call a customer based on past successful right-party contacts.

Larger collection units also use champion/challenger technology, as described in the "Account Management" section of this booklet. The collection area devises strategies designed to enhance productivity, i.e., to improve its customer contact rates and elicit the best responses in terms of dollars collected and losses averted at the lowest possible cost. Consequently, unit management routinely fine-tunes the types of borrower contact (call

versus letter, etc.) as well as the timing of those actions. Strategies are applied to portfolio segments based on the borrowers' risk profiles, dollars at risk, and other variables. Call intensity increases as the customer rolls through delinquency buckets or does not fulfill a promise to pay. The bank's risk management process should work closely with collections to develop strategies, analyze results, and make modifications as warranted.

No approach is necessarily better than another. Rather, each bank should adopt an approach best suited to its needs based on its infrastructure, staffing expertise, collection objectives, portfolio/borrower characteristics, and the collection tools available.

Analysis

Account management and collection practices can distort the portfolio's reported performance. Key among these practices are credit extensions, deferrals, renewals, and rewrites. These cure programs are addressed in OCC Bulletin 2000-20 and should be governed by reasonable bank policies, tracked, and supported by adequate documentation. Banks' policies for cure or forbearance programs should result in reasonable amortization periods and should generally prohibit negative amortization. These guidelines should also apply to punitive pricing programs.

Cure or forbearance programs present a viable means of working with customers to address short- and long-term financial hardships. The bank should have an accurate and realistic assessment of the borrower's impairment to assess if it is short-term or long-term. Generally, long-term financial hardships should not be addressed with short-term workout plans.

Forbearance is an agreement that allows reduced payments or suspends payments to address temporary financial hardships for a specific period, usually not to exceed three months. The borrower still owes the unpaid amount, which may be worked out later with a loan modification. Rewrites are a possible exception and can be compared with restructured credit in commercial lending, in which the financial difficulty is extended but some capacity to perform still exists. In no event should these programs be used to defer losses. Liberal and unsubstantiated use of cure programs is imprudent and should be criticized.

The volume and trends in delinquencies and losses are central to the evaluation of collection and overall portfolio performance. Portfolio growth can mask true performance. Consequently, in addition to monitoring the absolute levels of past dues and charge-offs and their trends, examiners should look at these numbers on "vintage" and "lagged" bases.

- **Vintage:** Refers to grouping loans made in a given time period for analysis purposes. For example, the performance of all new car loans made in June 2015 would be tracked separately for trends and then compared against the performance of other vintages to identify anomalies.
- **Lagged:** Uses the current amount of the item of interest as the numerator (e.g., loans past due 30 days or more or charge-offs), and the outstanding balance of the portfolio being measured for some earlier time period as the denominator—generally six months or one year ago. Lagged analysis is particularly helpful when a bank has experienced rapid

growth. A large volume of new loans being booked can mask credit problems by artificially lowering the current delinquency ratio as new loans (which would not yet be delinquent) are added to the denominator.

Both methodologies help smooth the effects of growth, and banks of all sizes should perform these analyses to better understand the conditions and dynamics of their portfolios.

Nonaccrual Status (Updated 1/6/2017)

Banks should follow the Federal Financial Institutions Examination Council's "Instructions for Preparation of Consolidated Reports of Condition and Income" (call report instructions) when determining the accrual status for consumer loans. As a general rule, banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete a discount on any asset if

- the asset is maintained on a cash basis because of deterioration in the financial condition of the borrower,
- payment in full of principal or interest is not expected, or
- principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.[20]

The call report instructions provide two exceptions to the general rule:[21]

(1) Consumer loans and loans secured by a one- to four-family residential property need not be placed in nonaccrual status when principal or interest is due and unpaid for 90 days or more. Nevertheless, consumer and one- to four-family residential property loans should be subject to other alternative methods of evaluation to assure that the bank's net income is not materially overstated. To the extent that the bank has elected to carry a consumer or one- to four-family residential property loan in nonaccrual status on its books, the loan must be reported as nonaccrual in the bank's call report.
(2) Purchased credit-impaired loans need not be placed in nonaccrual status when the criteria for accrual of income under the interest method specified in ASC Subtopic 310-30, "Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality," are met, regardless of whether the loans had been maintained in nonaccrual status by the seller. For purchased credit-impaired loans with common risk characteristics that are

[20] An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

[21] For more information, refer to the "Nonaccrual Status" entry in the "Glossary" section of the call report instructions. This entry describes the general rule for the accrual of interest, as well as exceptions for retail loans. The entry also describes criteria for returning a nonaccrual loan to accrual status.

aggregated and accounted for as a pool, the determination of nonaccrual or accrual status should be made at the pool level, not at the individual loan level.[22]

As a general rule, a nonaccrual loan may be restored to accrual status when

- none of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest, or
- it otherwise becomes well secured and is in the process of collection.

The OCC's *Bank Accounting Advisory Series* and the "Rating Credit Risk" booklet of the *Comptroller's Handbook* provide more information for recognizing nonaccrual loans, including the appropriate treatment of cash payments for loans on nonaccrual status.

Consumer Debt Sales

As providers of consumer credit, banks lend money to be repaid with interest. Banks underwrite the loans and price them according to the risk associated with the type of lending and the customers' creditworthiness. A percentage of banks' loans go unpaid. Under guidelines set out in OCC Bulletin 2000-20, banks should generally charge off closed-end credit at 120 days past due. Although the bank has charged off the loan, the borrower generally still has an obligation to repay the debt. At that point, the bank faces a business decision on how to recover the loss or whether to pursue collection at all.

Debt collection can take several forms, including continued efforts by the bank to collect, the hiring of a third party to collect the debt on the bank's behalf, and the sale of the debt to an unaffiliated third party, which generates a partial recovery. Although the majority of debt that banks charge off and sell to debt buyers is credit card debt, banks also sell to debt buyers other delinquent installment loans, such as automobile loans. Most debt sale arrangements involve banks selling debt outright to debt buyers. Banks may price debt based on a small percentage of the outstanding contractual account balances. Typically, debt buyers obtain the right to collect the full amount of the debts. Debt buyers may collect the debts or employ a network of agents to do so. Notably, some banks and debt buyers agree to contractual "forward-flow" arrangements, in which the banks continue to sell accounts to the debt buyers on an ongoing basis. This section focuses specifically on debt sales, but many of the principles also apply when the bank hires a third party to collect debt on its behalf.

Banks that sell consumer debt should have policies, procedures, and practices that result in the third party treating customers fairly and consistently. Increased risk most often arises from poor planning, lack of oversight, and inferior performance or service on the part of the debt buyer, and may result in legal costs or loss of business. Selling debt to a debt buyer can significantly increase a bank's risk profile, particularly in the areas of operational, reputation, compliance, and strategic risks.

[22] For more information, refer to the "Purchased Credit-Impaired Loans and Debt Securities" entry in the "Glossary" section of the call report instructions.

- **Operational risk:** Inadequate systems and controls can place the bank at risk for selling debt with inaccurate information regarding account characteristics.
- **Reputation risk:** Banks can lose community support and business when they sell consumer debt to debt buyers that engage in practices perceived to be unfair or detrimental to customers.
- **Compliance risk:** This risk exists when banks do not appropriately assess current and ongoing debt buyer collection practices for compliance, or when the debt buyer's operations are inconsistent with law, ethical standards, or the bank's policies and procedures.
- **Strategic risk:** Bank personnel should carefully analyze decisions to sell debt to debt buyers to ensure consistency with the bank's strategic goals and to ensure capable management and staff are in place to perform due diligence and carry out debt sales.

Examiners should refer to OCC Bulletin 2014-37, "Consumer Debt Sales: Risk Management Guidance," while reviewing bank debt sales activities. Examiners should also refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," which explains how to effectively manage risks associated with third-party service providers, including third-party vendors collecting debt on behalf of the bank (debt placement relationships), as well as a bank's relationship with buyers of its debt (debt sales relationships). Additionally, examiners should complete a careful review of these sales to determine a bank's compliance with the accounting requirements for de-recognition (refer to ASC 860, "Transfers and Servicing," for discussion of de-recognition).

Federal statutes applicable to debt sales include the following:

- **Fair Debt Collection Practices Act:** This act applies to debts incurred primarily for the consumer's personal, family, or household purposes. Under this act, "debt collector" is defined broadly to generally encompass debt buyers working on behalf of original creditors, including banks.[23]
- **Fair Credit Reporting Act:** This act, which is implemented by Regulation V, regulates the collection, dissemination, and use of consumer information, including consumer credit information.[24]
- **Gramm–Leach–Bliley Act:** Certain provisions of this act and Regulation P, which implements certain provisions of the act, contain requirements that require banks to provide consumers with privacy notices when the consumer relationships are established and annually thereafter. In addition, this law imposes limitations on banks' sharing of nonpublic personal information with debt buyers.[25]

[23] Refer to 15 USC 1692-1692 et seq., "Congressional Findings and Declaration of Purpose."

[24] Refer to 15 USC 1681-1681 et seq., "Congressional Findings and Statement of Purpose," and 12 CFR 1022, "Fair Credit Reporting (Regulation V)".

[25] Refer to 15 USC 6801, "Protection of Nonpublic Personal Information," and 12 CFR 1016, "Privacy of Consumer Financial Information) (Regulation P)".

- **Equal Credit Opportunity Act:** This act and its implementing regulation, Regulation B, prohibit discrimination in any aspect of a credit transaction on a "prohibited basis."[26]
- **Federal Trade Commission Act:** Section 5 of this act prohibits unfair or deceptive acts or practices in or affecting commerce. Public policy may also be considered in determining whether an act or practice is unfair.[27]

Secured Loans Discharged in Chapter 7 Bankruptcy

One of the primary purposes of Chapter 7 bankruptcy is to discharge certain debts and give individual debtors a fresh start. Discharge orders prohibit creditors from taking certain types of collection actions. These prohibitions restrict communications with borrowers regarding debt collection, including by telephone, mail, or personal contact. Creditors can enforce repayment only through foreclosure or repossession of the collateral consistent with state laws and not through collection actions against the borrower.

As discussed in OCC Bulletin 2000-20, the portion of the debt exceeding the collateral value should be charged off within 60 days of notification of filing unless the bank can clearly demonstrate and document that repayment is likely to occur even though the borrower no longer has personal liability for the debt.[28] Any balance not charged off should be classified substandard. Banks should either place these loans in nonaccrual status or follow other acceptable methods (for example, interest reserves) to ensure that revenue recognition is not overstated when collection of principal and interest in full is in doubt. This approach is particularly relevant to Chapter 7 filings because

- Chapter 7 bankruptcy filings are significant events, generally prompted by a severe hardship or significant change in financial condition that affects a borrower's willingness or ability to repay existing debt.
- when a debt is discharged, it indicates that both the borrower and the bankruptcy court have determined that the borrower no longer has the capacity to service all of his or her debt as structured and that it is no longer in the borrower's best interest to remain obligated to repay the debt as agreed.
- generally practical reliance on the primary source of repayment can no longer be assured, which fundamentally changes the nature of the relationship and the lender's ability to actively manage exposure through normal account management and collections procedures.

Given these factors, Chapter 7 bankruptcy exposures should be managed as troubled assets, with resolution steps aimed at prudent loss mitigation and principal recovery pursuant to actions permitted by the bankruptcy process. In some cases, however, borrowers continue to make payments and remain contractually current even though the court has discharged the debt and the borrower no longer has any personal liability. In these situations, questions arise

[26] Refer to 15 USC 1691-1691 et seq., "Scope of Prohibition," and 12 CFR 1002, "Equal Credit Opportunity Act" (Regulation B).

[27] Refer to 15 USC 45, "Unfair Methods of Competition Unlawful; Prevention by Commission."
[28] The bankruptcy filing could be used to document that repayment is likely to occur.

regarding how to classify exposures at the time of receipt of notice of the filing, and whether being contractually current mitigates the need to recognize a charge-off, adverse classification of the loan, or placement of the loan in nonaccrual status.

A borrower's payment history is an important historical indicator, but remaining contractually current may not by itself demonstrate that the borrower will continue future orderly repayment. Avoiding loan charge-off and nonaccrual entails a credible, objective analysis that considers whether repayment of principal and interest is likely to occur despite the bankruptcy discharge. If a post-discharge credit analysis can document that structured, orderly repayment is expected, and the borrower has demonstrated a willingness to repay, then charge-down to collateral value and nonaccrual status are not required.[29] OCC Bulletin 2014-4, "Secured Consumer Debt Discharges in Chapter 7 Bankruptcy," provides additional guidance for banks regarding secured consumer debt discharged in Chapter 7 bankruptcy proceedings.

Ultimately, it is the banks' responsibility to accurately risk rate and report these assets in their regulatory reports and financial statements in accordance with generally accepted accounting principles (GAAP)[30] and regulatory reporting instructions, including appropriate income recognition, troubled debt restructuring (TDR) designation, impairment measurement, and timely charge-off.

Accrual Status

Banks must follow "Instructions for the Consolidated Reports of Condition and Income" when determining the accrual status of secured customer debt that has been discharged in Chapter 7 bankruptcy. For guidance on when nonaccrual status is appropriate, refer to the "Glossary" section of the Federal Financial Institutions Examination Council's (FFIEC) Consolidated Report of Condition and Income (call report) available on the FFIEC's Web site. Consistent with GAAP, banks are expected to follow revenue recognition practices that do not result in overstating income.[31]

Treatment of Payments Received Post-Discharge

Any application of cash payments received on nonaccrual assets, as well as restoration to accrual status, must follow call report instructions and GAAP. When collectability of the recorded investment is in doubt, any payments received are to be applied to reduce the recorded investment in the loan until such time as doubt is eliminated. While assets are in nonaccrual status, some or all of the cash interest payments received may be reported as interest income on a cash basis so long as the remaining recorded investment in the loan (that is, the investment after charge-off of identified losses, if any) is deemed fully collectible. The determination of the ultimate collectability of the remaining recorded investment should be

[29] Refer to 12 USC 1831n, "Accounting Objectives, Standards, and Requirements."

[30] Refer to footnote 26.

[31] Refer to footnote 26.

supported by a current, well-documented analysis of the borrower's financial condition and prospects for repayment. This analysis includes consideration of the borrower's historical repayment performance and other relevant factors.

TDR Determination

In determining whether secured customer debt discharged in Chapter 7 bankruptcy is a TDR, banks need to assess whether the borrower is experiencing financial difficulties and whether the bank has granted a concession to the borrower. To determine whether there has been a concession,[32] banks should consider all facts and circumstances, including changes to the legal rights and obligations of the lender and borrower resulting from the Chapter 7 bankruptcy filing and discharge. Banks should also consider the effects of bankruptcy on other applicable federal and state laws governing the loan agreements, the impact of the bankruptcy on the available sources of repayment, and the amount and timing of the cash flows.

Impairment Measure

The methodology a bank uses to measure impairment is subject to all relevant GAAP and supervisory guidance. Generally, customer loans are collectively evaluated for impairment under ASC 450, "Contingencies." For customer loans that are TDRs, however, banks are generally required to measure impairment consistent with ASC 310-10, "Receivables," using either the net present value method (that is, the net present value of future cash flows discounted at the loan's original effective interest rate) or, when the loan is collateral dependent, the fair value of the collateral method.[33]

Banks should consider all available and reliable data and evidence, including collateral values, in developing impairment estimates, with factors weighed commensurate with the extent to which the evidence can be verified objectively. Although the legal status of the discharged loan is collateral dependent, if the bank's credit analysis and objective evidence (using the framework discussed above and in OCC Bulletin 2014-4, "Secured Consumer Debt Discharged in Chapter 7 Bankruptcy") support the conclusion that continued cash flow is expected from borrowers, then impairment should be measured based on the net present value method, not solely on the collateral value.[34] When available information confirms that specific loans or portions of loans are uncollectible, these amounts should be promptly charged off against the ALLL.

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[32] Including concessions granted by the bankruptcy court.

[33] Refer to footnote 26. Refer to OCC Bulletin 2012-10, "Troubled Debt Restructurings: Supervisory Guidance on Accounting and Reporting Requirements." Refer to *Bank Accounting Advisory Series*, "Topic 2A: Troubled Debt Restructurings," September 2015 for discussion of TDR and nonaccrual status.

[34] Refer to footnote 26.

Allowance for Loan and Lease Losses

Banks are required to establish an ALLL to cover losses that are probable and estimable, and to regularly review and maintain its appropriateness.[35] Although the ALLL provides protection against expected losses, capital provides the cushion for unexpected losses. Refer to the "Allowance for Loan and Lease Losses" booklet of the *Comptroller's Handbook* for an in-depth discussion of this topic, including the applicable accounting standards, examination procedures, and other considerations.

Under OCC Bulletin 2000-20, banks should charge off closed-end credit at 120 days past due (and open-end credit at 180 days past due), with certain exceptions for real estate-secured loans. OCC Bulletin 2000-20, however, also stipulates that accounts should be charged off earlier if the loss is apparent. ALLL methodologies that banks adopt should reflect those guidelines.[36]

Because of the sheer volume of loans involved, analyses to determine an appropriate allowance allocation for installment loan portfolio losses are typically performed on a pooled basis. Generally, inherent losses are estimated for groups of homogeneous loans, i.e., those with common characteristics, usually product type. If performance varies significantly for a group of identifiable loans within a given product, a separate analysis of that group would be appropriate. For example, automobile loans originated through a specific dealer or group of dealers may perform significantly better or significantly worse than other indirect automobile loans. The more the bank segments its portfolio into groups of similarly performing loans, the more reliable the ALLL analysis.

Note that in small community banks with only limited activity, a loan-by-loan loss analysis may be appropriate. In these circumstances, the bank should document its criteria for estimating losses and how those criteria are applied to individual loans.

Almost all installment loan products involve the remittance of monthly payments. This promotes effective analysis because payment stream interruptions (i.e., delinquencies) are indications of credit weakness, and the more pronounced the interruption, the greater the chance of loss. Therefore, pool analysis typically begins with an assessment of historical roll-rates. As stated previously, roll-rates measure the movement of accounts from one performance category to another (e.g., from current to 30 days delinquent or from 60 to 90 days delinquent), and, ultimately, to loss. (Conversely, accounts can roll from 60 to 30 days past due or to current.) Once quantified, these historical proxies can be applied to accounts currently residing in each payment status to determine the dollar amounts expected to roll to loss. Roll-rate analysis tends to lose its predictive power after the contractual charge-off date. The bank should, however, lengthen or shorten the historical perspective as warranted to more heavily weight recent experience or to reflect changes in the economic environment

[35] Refer to footnote 26.
[36] Refer to OCC Bulletin 2001-37, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions." Also refer to OCC Bulletin 2012-6, "Interagency Guidance on ALLL Estimation Practices for Junior Liens: Guidance on Junior Liens."

(e.g., if conditions are worsening, the bank should use a shorter period). Refer to appendix F, "Loss Forecasting Tools," of this booklet for more information.

Although the analysis may begin with loss projections based on historical roll-rates, the analysis is not complete without incorporating additional factors. For example, projected loss rates for loans in any type of cure program should be determined separately. Cure programs include extended, deferred, rewritten, or renewed loans, such as loans in consumer credit counseling (CCC) programs (external debt management plans) or bank-sponsored workout programs. In addition, historical loss experience for each analysis component should be reviewed and, as warranted, adjusted for changes to underwriting standards or account management practices, portfolio composition (including concentrations) and volume, factors relating to the competitive and economic environment, and the other factors discussed in the "Allowance for Loan and Lease Losses" booklet of the *Comptroller's Handbook*.

In general, banks should provide for at least 12 months' coverage of projected losses for their installment loan portfolios.[37] Assuming that the methodology and assumptions the bank used are sound, the resulting analysis determines the proper level and coverage of the ALLL. Additionally, loss emergence periods should be considered.

Profitability

Long-term "through the cycle" profitability is generally the ultimate barometer of the success for each product offered by the bank and for the bank's overall portfolio. The most frequently used profit measures are return on equity and return on average assets. Retail profit models, underlying management assumptions, and the profit reporting structure vary widely among banks and retail products. Examiners should have a fundamental understanding of the bank's products and be cognizant of the corporate and product line business plans and strategies before drawing conclusions regarding product profitability.

Understanding business and strategic plans is the first step in reviewing profitability. In some situations, product profitability is secondary to other considerations. For example, some products may be priced with limited profit potential to achieve growth objectives or gain market share. Therefore, to reach the correct conclusion on product profitability, examiners must first understand the role installment lending plays in the bank's overall strategy. Achieving a sufficient profit level to keep internal and external constituents satisfied is often one of the most important issues facing managers of installment lending activities.

Pricing decisions in installment lending can significantly influence the bank's overall profitability. To effectively manage pricing decisions and profitability, senior management should develop detailed profit objectives, a monitoring system, and planning models. There should be an individual or unit within the bank who may or may not reside within the line of business and who is accountable for maintaining the profit and loss statement, earnings forecasts, and budgets for each product. Generally, this individual or unit reports directly to the head of the line of business or to someone in the finance department. Senior management

[37] OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses (ALLL): Guidance and Frequently Asked Questions (FAQs) on the ALLL."

should regularly discuss each product's current and forecasted earnings performance with this individual or unit to ensure that profit expectations are in line with the reality and dynamics of the line of business.

The bank should have a system that accurately reports product profitability. Profitability should be reported for each credit product on a monthly basis, and such reporting should include all related revenues and expenses. All direct and indirect costs should be fully allocated to avoid false reads on profitability. Also, detailed profitability reporting for each significant business segment is extremely important. Examples of business segments in indirect auto portfolios might include auto loans versus leases or significant dealer relationships.

In addition, the existing portfolio and new business volume should be split into risk-graded segments, and MIS should detail profitability based on risk. Examiners should review performance in the context of management objectives, organizational costs, product price sensitivity, board-approved risk appetite, and outside effects, such as the economy and competition.

The profit statement for the line of business should detail all revenues and expenses. Major revenue items often include interest income, service revenues, and fees (late and extension). Major expense items typically include the cost of funds, provision expenses, and the expenses associated with marketing, systems, personnel and administration (overhead), and fraud. To construct accurate profit and loss statements, the bank should maintain systems that can generate the required information. In many instances, assumptions should be made on how to allocate costs, including personnel and overhead. Such costs may not be precisely calculable. Management should maintain documentation on these assumptions and periodically reevaluate their accuracy. Management's knowledge of profit and expense drivers, especially operational costs, is essential to its effective management of the installment lending activities.

When examiners review profit and loss statements for installment lending products, it is critical to have an understanding of industry baselines for the respective product being reviewed. There are a number of ongoing industry studies prepared for retail credit products, such as auto lending and leasing. These reports provide valuable information for comparative purposes, indicating when the bank is outside normal ranges for a particular line item. The use of industry baseline data to better understand the dynamics of the particular line of business and to generate discussion points for management is strongly recommended.

When examiners evaluate product profitability, it is important to consider the types and terms of pricing programs in effect. There may be numerous introductory interest rate offers, contests, etc., that could have a material impact on current and future earnings. Management should generate reports that detail such programs.

Third-Party Management

Banks are increasingly outsourcing various components of their lending operations to third-party vendors. Vendors include affiliates, brokers, dealers, data processors, consultants, attorneys, collection companies, marketing firms and telemarketers, and modeling firms—in short, any entity that can perform a function or provide a service on the bank's behalf.

Banks may elect to use outside vendors for any number of reasons, but the most common include cost savings, capacity considerations, and access to expertise, technology, or certain acquisition channels. Although outsourcing is often justified, management should recognize that reliance on third parties for functions integral to the bank's operations always introduces additional risk. This is particularly true when vendors have significant contact with the bank's customers or when the bank relies heavily on the vendor but does not monitor the vendor effectively. Consequently, the bank should maintain an effective vendor management program.

Outsourcing a function does not in any way lessen the bank's responsibilities in connection with that function. A bank should have a higher degree of diligence when outsourcing a function, not only to ensure adherence to management expectations but also to assess compliance with laws and regulations, as well as consistency with supervisory guidance, such as OCC bulletins and advisory letters.

The purpose of a bank's vendor management program is to assess whether vendors act in accordance with established policies and procedures, legal requirements, and applicable Federal banking agency issuances, and to determine that vendors employed by the bank have the financial capacity to continue delivering the contracted services.[38] OCC Bulletin 2013-29, "Third-Party Relationships: Risk management Guidance," specifically defines a third-party relationship as an arrangement between a bank and another entity by contract or otherwise. Consequently, vendor management entails everything from suitable due diligence and the proper design of contracts (with the clauses necessary to monitor and enforce compliance) to monitoring performance. Basically, the bank should take steps to ensure that the vendor treats the bank's customers and potential customers in a manner consistent with the way the bank would treat them itself.

The level of oversight afforded each vendor varies based on the circumstances and the level of risk involved with the function being outsourced. For example, although the bank typically verifies purchase invoices for an office supply vendor, it may not conduct any type of ongoing monitoring of that vendor. On the other hand, if the bank contracts with a vendor for telemarketing services or collections, the vendor is deemed to be engaging in a significant activity on behalf of the bank, and the bank should employ a more rigorous program of due diligence and ongoing oversight. Once a vendor is designated as significant, in terms of the cost of the contract or the importance of the service provided, vendor management personnel should determine the necessary level of oversight in light of the risks presented. Senior

[38] Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," which defines a third-party relationship as an arrangement between a bank and another entity, by contract or otherwise.

management should periodically assess existing third-party relationships to determine whether the nature of the activity performed constitutes a critical activity.

Developing a management oversight process for each vendor entails defining the scope of the vendor's activities, assessing the risks, and designing a monitoring program to ensure that those risks are satisfactorily controlled. Using a cross-functional team to monitor the various control functions, including a representative from the line of business using the vendor, promotes more complete identification of the risks involved, desirable performance criteria and MIS reports, and the resources needed to manage the risks identified. Ideally, this process is conducted for new vendors before finalizing contracts to ensure that the contracts provide the clauses needed for oversight of vendor management. Ongoing monitoring for the duration of the third-party relationship is an essential component of the bank's risk management process.

After entering into a contract with a third party, bank management should dedicate sufficient staff with the necessary expertise, authority, and accountability to oversee and monitor the third party commensurate with the level of risk and complexity of the relationship. Regular on-site visits may be useful to understand fully the third party's operations and ongoing ability to meet contract requirements. Management should ensure that bank employees who directly manage third-party relationships monitor the third party's activities and performance. A bank should pay particular attention to the quality and sustainability of the third party's controls and the vendor's ability to meet service-level agreements, performance metrics, and other contractual terms and to comply with legal requirements.

For more information, refer to OCC Bulletin 2013-29, which provides guidance with respect to vendor management.

Asset Securitization

Asset securitization began with the structured financing of mortgage loan pools in the 1970s. The market continued to evolve with the securitization of auto loans and credit card receivables in the mid-1980s. Since then, banks and other financial services providers have significantly increased their use of asset securitization to fund receivable growth, provide liquidity, manage their balance sheets, and generate fee income.

The three major parties to each securitization are the originator, the investor, and the borrower. Each of these parties benefits to some degree from a securitization transaction, but for purposes of this discussion, we are limiting our analysis to the effects on the originator. The originator generally improves returns on capital by converting on-balance-sheet assets into off-balance-sheet fee income streams, thus freeing up capital for other opportunities. Depending on the type of structure used, securitizing assets may lower borrowing costs and enhance asset/liability and credit risk management. Securitizations may not, however, fully transfer the associated credit risk to the investors: The issuer may absorb the first credit losses. Consequently, if credit losses increase, based on the loan sales contract, the bank's net income stream from these assets may be reduced or eliminated.

The type of collateral supporting a securitization often dictates its structure. For example, automobile installment loans, which have defined amortization schedules and fixed maturity dates, have a different securitization structure than credit card loans, which have no specific amortization schedule or final maturity date. The type of collateral may also dictate the type of trust structure that is used. The trust insulates the assets from the reach of an issuer's creditors and provides favorable tax treatment to the related parties.

The distribution of cash in a securitization is often referred to as the "cash flow waterfall." This waterfall differs from one transaction to another and is directly affected by the portfolio yield, loss rates, monthly payment and prepayment rates, and other pertinent factors depending on the type of collateral. It is critical to understand the composition of the cash flow waterfall and its trends to fully analyze the status and impact of the securitization.

Responsibility and accountability for, and oversight of, the securitization by competent individuals are imperative to the securitization's ongoing management and success. Internal controls, including independent reviews of securitization processes and models, are important in limiting risk to earnings and capital. Regular impairment testing of retained interests and any servicing asset(s) is essential. Model assumptions should be reviewed quarterly and should include back-testing to determine whether adjustments are necessary.

The "Asset Securitization" booklet of the *Comptroller's Handbook* describes this process and provides guidance on banks' management of asset securitizations. OCC Bulletin 1999-46, "Interagency Guidance on Asset Securitization Activities," also provides relevant guidance. Examiners should refer to these materials for more detailed information and guidance with respect to asset securitization activities and examination procedures.

Stress Testing

Although the ALLL covers the bank's expected credit losses, capital should be sufficient to absorb unexpected losses. Stress testing is an important tool for estimating these unexpected losses. Banks have historically employed various stress testing techniques in their commercial loan programs, but application of these techniques to the retail credit portfolio is relatively new. Stress testing should be performed annually for each major retail credit product line, and more frequently if the product has significant revenue implications for the bank.

Effective stress testing measures changes in the quality and performance of the portfolio as a result of best, worst, and most likely economic or market deterioration scenarios. Results are assessed from the standpoint of impact on earnings and capital. Management and the board should use this information to determine whether policy or other changes are warranted.

Portfolio testing should include "shock" testing of forecasting assumptions for basic performance characteristics, such as delinquency, loss, and recovery rates. It should also consider changes to other variables, such as attrition or prepayment rates, utilization rates for revolving products, credit score distributions, and, if applicable, capital markets' demand for whole loans or asset-backed securities supported by retail products. Factors to be considered

vary by product, market segment, and the size and complexity of the portfolio relative to the bank's overall operations.

Stress testing can be performed either manually or through automated modeling techniques. Regardless of the method, the process should be clearly documented, rational, and easily understood by the bank's board and senior management. Care should be taken to ensure that the inputs are reliable and relate directly to the subject portfolio (i.e., the loss history is specific to the product evaluated, not a blend of several or all products), and that the assumptions are reasonable. If the bank uses a model, the model should be well documented and validated.

As with other types of analysis, the size of the retail credit portfolio, its importance to bank earnings, and the complexity of the products offered dictate the form of the stress testing process. Although small community banks with limited involvement in retail lending may employ a simple spreadsheet analysis, large retail lenders often use sophisticated models to develop their scenarios. Irrespective of the bank's size and complexity, management should have a reasonable process for ensuring that capital is adequate to support the bank's retail lending activities, and stress testing is a valuable component of this process. The following guidance addresses the requirements of the Dodd–Frank stress test rules as well as illustrative examples of satisfactory practices: OCC Bulletin 2012-33, "Community Bank Stress Testing: Supervisory Guidance"; OCC Bulletin 2014-5, "Dodd–Frank Stress Testing: Supervisory Guidance for Banking Organizations With Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion"; OCC Bulletin 2012-14, "Interagency Stress Testing Guidance"; and OCC Bulletin 2012-41, "Stress Testing: Final Rule for Dodd–Frank Section 165(i)." Examiners should refer to these materials for more detailed information and examination guidance with respect to stress testing.

Debt Suspension and Cancellation

A national bank is authorized to enter into debt cancellation contracts (DCC) and debt suspension agreements (DSA) and to charge a fee for these services, in connection with extensions of credit.[39] The contracts or agreements provide for the cancellation or suspension of loan payments when it becomes difficult for the borrower to make payments. "Debt cancellation contract" means a loan term or contractual arrangement modifying loan terms under which a bank agrees to cancel all or part of a customer's obligation to repay an extension of credit from the bank upon the occurrence of a specified event. The agreement may be separate from or a part of other loan documents. DSA does not include loan payment deferral arrangements in which the triggering event is either the borrower's unilateral election to defer repayment or the bank's unilateral decision to allow a deferral of repayment.

A national bank should manage the risks associated with DCCs and DSAs in accordance with safe and sound banking principles and must ensure compliance with all applicable laws and regulations. Accordingly, a national bank should establish and maintain effective risk management and control processes over its DCCs and DSAs. Such processes include appropriate recognition and financial reporting of income, expenses, assets, and liabilities

[39] Refer to 12 CFR 37, "Debt Cancellation Contracts and Debt Suspension Agreements." FSAs are not subject to 12 CFR 37 but are expected to have appropriate risk management processes for these products.

and appropriate treatment of all expected and unexpected losses associated with the products. A bank also should assess the adequacy of its internal control and risk mitigation activities in view of the nature and scope of its DCC and DSA programs. Examiners should refer to the debt suspension and cancellation examination procedures in this booklet as well as appendix D, "Debt Suspension Agreement and Debt Cancellation Contract Forms and Disclosure Worksheet," and appendix E, "Debt Suspension and Debt Cancellation Product Information Worksheet."

Product Profiles

The following sections provide brief overviews of banks' most common installment loan products, including early warning signs of potential safety and soundness problems. Although subprime lending exists to varying degrees in each of these product areas, the heightened risks associated with subprime lending are not specifically addressed. For more subprime guidance, refer to OCC Bulletin 1999-10, "Subprime Lending Activities"; OCC Bulletin 1999-15, "Subprime Lending: Risks and Rewards";[40] and OCC Bulletin 2001-6, "Expanded Guidance for Subprime Lending Programs."

Clearly, compliance risk is an integral component of installment lending, and there are consumer compliance-related laws and regulations associated with each of the products discussed. Although this booklet does not address compliance with legal requirements, examiners should evaluate compliance using the numerous consumer compliance resources available.

Indirect Loans

Because indirect lending is a highly competitive business often dominated by the "captive" financing arms of the manufacturers, margins have compressed to the point that a lender cannot afford shortfalls or deficiencies in credit selection or pricing. Consequently, the bank's underwriting criteria should be carefully developed and regularly revisited. In addition to creditworthiness criteria common throughout retail lending, indirect criteria should also include deal-related considerations, such as LTV/advance rate limitations and other collateral-based guidelines (new versus used, size of the transaction, down payment, and options financed). Together, these factors dictate the maximum amount financed, interest rate, and term of the loan.

Beyond individual loan underwriting standards, banks should also implement prudent portfolio mix and concentration limits. For example, guidelines should be established for credit risk/grades, new versus used, loan terms, manufacturer and model, and dealers.

Disposition management is a key function in indirect lending. When a loan defaults and the collateral is repossessed, the bank's challenge is to dispose of that collateral as promptly and profitably as possible. The bank may involve the originating dealer in this process or it may attempt to sell the collateral on its own. In the largest operations, repossessions are routinely

[40] OCC Bulletin 1999-15 does not apply to FSAs.

sold at auction, and repossessed collateral may even be transported to auctions in other states if the recovery rates are significantly higher.

Effective dealer management is also a critical component of successful indirect lending. Banks should have systems to promptly identify and respond to problems or changes in dealer performance. In some cases, this may result in termination of the relationship. Dealer management relies on the dealer's implementation and use of accurate and complete MIS. Dealer MIS should include

- monthly and year-to-date application volumes (received, approved, and booked).
- credit quality, exception rates, and performance of booked loans (delinquencies, charge-offs, early payment defaults, or extensions).
- early payoffs.
- average margins.
- relationship profitability.

Other dealer arrangements, such as recourse and dealer reserve accounts, should also be tracked and managed. Dealer recourse (i.e., the dealer agrees to buy back certain contracts in default) is not common in today's market. Rather, dealer reserves, which are bank-controlled deposit accounts funded by the difference between the customer contract rate and the bank buy rate are maintained and distributed per the terms in the dealer agreement. Although dealer distributions are often adjusted to reflect early contract payoffs or defaults, reserve accounts are not as tightly controlled as they have been historically.

Banks that use third parties in the application or underwriting process have increased fair lending risk. An application taken by a third party presents additional risks as the bank has less control over the training and activities of the loan originators. Banks are responsible for the actions of third parties acting on the bank's behalf or for loans that the bank purchases through third parties. Pricing set by third parties presents unique risks to a bank, as the bank is ultimately responsible for the loans that go into its portfolio as well as the pricing composition of the loans that make up the portfolio. Programs that permit third parties to set loan pricing or dealer compensation not related to the credit worthiness of the applicant increase fair lending risk. To properly manage fair lending risk, banks should have effective risk management systems in place including appropriate due diligence and management of third parties, fair lending risk assessment or analysis, and appropriate secondary review or audit processes.

Indicators of potential problems in a bank's indirect lending program include

- excessive growth, particularly when coupled with relaxed underwriting, the use of new channels, or entry into new market areas.
- liberal loan terms, including underwriting criteria and loan duration.
- outlier pricing, above or below the market.
- high or increasing levels of policy exceptions (credit grade, term, LTV or failure to track policy exceptions.
- increasing early payment defaults, delinquencies, and losses (frequency and severity).

- increasing use of cure programs, including extensions or deferrals, renewals, and rewrites.
- significant increase in repossessions or loss per repossession.
- unsecured deficiency balance financing following repossession.
- increasing delinquency and repossession rates coupled with insufficient collection staff.
- concentrations in one manufacturer, model, dealer, or vintage.
- lack of effective dealer management, including a comprehensive program, adequate MIS, and timely response to identified issues.
- pricing discretion is permitted when setting the terms of the loan.
- unmonitored third-party compensation programs.

Direct Loans

The main difference between direct and indirect lending is that, with direct lending, the bank typically has a preexisting relationship with the borrower. Consequently, assuming similar underwriting, direct loan portfolios tend to perform better than indirect, even if only marginally. This is particularly true in community banks with a strong local presence.

Indicators of potential problems in a bank's direct lending program include

- excessive growth, particularly when coupled with relaxed underwriting, the use of new channels, or entry into new market areas.
- liberal loan terms, including underwriting criteria and loan duration.
- outlier pricing, above or below the market.
- high or increasing levels of policy exceptions (credit grade, term, LTV, and rate, etc.), or failure to track policy exceptions.
- increasing early payment defaults, delinquencies, and losses (frequency and severity).
- increasing use of cure programs, including extensions or deferrals, renewals, and rewrites.
- significant increase in repossessions or loss per repossession.
- unsecured deficiency balance financing following repossession.
- increasing delinquency and repossession rates coupled with insufficient collection staff.
- concentrations in one manufacturer, model, dealer, or vintage.

Indirect Leases

The main differences between indirect lending and leasing lie in two areas: vehicle ownership and lease residuals. Regarding vehicle ownership in a lease transaction, the lessor/bank owns the vehicle and "rents" it to the lessee/customer for a specified period of time. In connection with lease residuals, the amount financed in a lease transaction is basically the negotiated cost of the vehicle less its "residual" value at the end of the lease term.

The residual value represents the expected fair market value of the vehicle at the end of the term of the lease. Quantifying the effects of depreciation and expected market conditions for

each make and model for each lease termination year is a difficult, complex process. Yet establishing accurate residual values is the core of the success and profitability of any leasing operation.

Many banks use residual value guidebooks, such as the Automotive Lease Guide (ALG) or the *Kelley Blue Book*, to establish these values. Once the residual value has been assigned, some lessors "enhance" residuals to attract leasing business for a given manufacturer or model. Enhancement, also known as subvention, involves increasing the residual value, thereby decreasing monthly payment amounts. Needless to say, enhancement is an effective tool for increasing volume; if the bank misses its projections, however, enhancement can be devastating to profitability.

The residual value may be higher or lower than the realized value at the scheduled end of the lease. Because the residual value is a best estimate of the vehicle's worth at end-of-term, some banks purchase residual insurance to insure the difference between the residual value and the end-of-term blue book or selling price, or some other agreed-upon criteria. There are many variations to these insurance policies, and the bank should analyze them individually to determine coverage parameters and limitations.

ASC 840 requires that banks review and reserve for residual impairment at least annually, but prudence suggests that banks should assess residual impairment at least quarterly. Impairment analyses or reports should be submitted to senior management and the board.

Upon expiration of a lease, the lessee can opt to purchase the vehicle or turn it in to the bank or the bank's designee. At this juncture, accuracy of the residual value becomes critical. If the vehicle's market value exceeds its residual value at end-of-term, the bank increases its chances for at least breaking even on vehicle disposition. If, however, the market value of the vehicle is significantly below the stated residual value, the bank faces a loss. Typically, lessees do not purchase the vehicle unless the bank discounts the price. A bank may incur even greater losses by selling the vehicle at auction, because of additional costs related to the auction process.

The bank's end-of-term management or loss mitigation unit is a critical function in any lease operation. This unit contacts the customer well in advance of lease maturity—how far in advance depends on residual exposure—to begin the process of explaining the lease termination process. The bank representative explains the inspection process and termination costs (excess wear and tear, excess mileage, etc.) and attempts to determine whether the customer intends to retain or return the vehicle. The bank typically begins negotiating vehicle purchase with the customer at this point. It may offer significant financial incentives to the customer to purchase the vehicle, such as loan financing or even the opportunity to re-lease the vehicle. The bank's offers are driven by considerations that include expected market values, costs of disposition, and a number of other variables focused on maximizing the bank's profitability and minimizing losses.

A bank's lease returns and repossessions typically are managed by remarketing units. These units manage the collateral liquidation process, just as in indirect automobile lending.

Indicators of potential problems in a bank's indirect lease program include

- liberal lease terms, including underwriting criteria and the duration of the leases.
- high or increasing levels of policy exceptions, or the failure to track policy exceptions.
- inadequate lease residual setting methodology or residual adjustment processes, and the existence of residual enhancements.
- building dealer add-ons into the residual value that do not translate into value at auction.
- inadequate analyses of residual risk and residual insurance needs.
- increasing delinquencies and charge-offs.
- high levels of extensions or rewrites.
- inadequate remarketing efforts in terms of either timing or diligence.
- concentrations in segments (e.g., sport utility vehicle, truck, car), manufacturers, model years, and models (particularly models considered to have higher residual risk).
- inadequate origination, valuation, and remarketing MIS.
- lack of a clearly defined and comprehensive third-party management program that provides for adequate tracking and management of each dealer relationship.

Manufactured Housing Loans

Generally, there are similarities among a bank's manufactured housing program and its other indirect lending programs. The manufactured housing loan transaction usually originates with an application to a dealer, who then shops the application to various banks. The financing is completed using a retail sales contract. The collateral may be considered chattel (titled personal property) or real estate, depending on governing state law. Many transactions involve financing only the manufactured housing unit, because most units are located on rented land, but there is also demand for combined land and home loans.

Typical manufactured housing contracts have higher interest rates and shorter maturities than those of site-built homes. Common terms for manufactured housing, without land, are 15- to 25-year maturities with minimum down payments of 5 percent to 10 percent. Advance rates often exceed dealer invoice because of options and the cost of affixing the unit to the land. Recovery rates on repossessed units are low because of high initial advance rates and the high costs of repossession.

Indicators of potential problems in a bank's manufactured housing loan program can be similar to those discussed in the "Indirect Loans" section of this booklet. For more information on the specifics of this unique business, contact the OCC's Retail Credit Risk Policy unit or the districts' Lead Retail Credit Experts.

Control Functions

The following control functions—loan review, QC, audit, and compliance—are no less important than risk and third-party management but are presented here in less detail because

they are covered extensively in the "Rating Credit Risk," "Compliance Management System," and "Internal and External Audits" booklets of the *Comptroller's Handbook.*

Loan Review

Periodic loan reviews should be independent and risk-based, focusing on both determining the adherence to approved policies and procedures and assessing the quantity of risk inherent in the portfolio(s) based on sampling results, MIS reports, and trends in portfolio risk profile and performance. Loan review coverage should be statistically valid and should specifically target portfolios concentrated in subprime or other new or unusual loan products. Additionally, the loan review procedures should strive to assess the

- quality of the risk management activities performed by lending personnel, including the level and performance of loans approved as exceptions to policies.
- quality and integrity of loan information within the automated systems or platforms for evaluating applications, servicing loans and lines, and collecting delinquent or charged-off loans.
- integrity and reliability of management portfolio reports for originations, servicing, and collections, including reports for deferrals, renewals, re-ages, modification of loans, classification of loans, and TDRs.[41]
- relevant trends in credit risk characteristics that may affect the collectability of the portfolio or ALLL calculations, including any reports of refreshed credit scores and real estate collateral values.

The credit review function for larger banks, or banks with complex installment lending activities, should also include transactional testing of accounts for underwriting and collections. A "best in class" credit review would also conduct continuous monitoring.

Quality Control and Assurance

Effective QC should begin with fundamental transaction testing and review and should be performed by an independent group, where a prescribed sample of applications of new or existing loans is reviewed for adherence to bank policies and procedures and to ensure that exceptions are properly identified and reported. QC performs reviews of loan and collateral documentation (paper and electronic files), verifications, and call monitoring, if applicable. Line management uses this information to assess the quality of its operations in terms of policy adherence, efficiency, and risk control. QC reviews also provide valuable information with respect to possible process modifications, training needs, and other staffing issues.

In addition to QC, QA is also important to the risk management process. Because it is more often a line management tool, it is not necessarily considered to be independent. Therefore, audit or one of the other control functions should routinely validate the adequacy of the QA process to determine the level of reliance that can be placed on its findings.

[41] Refer to *Bank Accounting Advisory Series*, "Topic 2A: Troubled Debt Restructurings," September 2015.

Audit

The board of directors should require risk-based periodic audits of the bank's installment lending activities. Audit procedures should include regular testing of the credit underwriting function for compliance with board-approved policies, applicable laws, regulations, and for consistency with guidance. Audit procedures should also review operational controls for proper segregation and independence of duties between loan personnel who assist the customer and facilitate the application process and staff members who disburse funds, collect payments, and provide the timely receipt, review, and follow-up on necessary loan documentation, including collateral valuations. Audits of compliance with the many consumer laws and regulations governing installment lending activities also should be conducted. Depending on the bank's size, internal or external auditors, separate compliance management or compliance audit functions may conduct these audits.

Compliance

Compliance with consumer laws and regulations is a high priority in installment lending. The risks associated with noncompliance with laws and regulations are significant in terms of both potential for monetary loss and damage to the bank's reputation. Therefore, ensuring compliance with consumer laws and regulations in all aspects of the operation warrants management's ongoing attention and diligence.

Every bank, regardless of size, should have a compliance program. A carefully devised, implemented, and monitored program provides a solid foundation for compliance. Management should evaluate the bank's organization and structure and create a program to meet its specific needs. Consideration should be given to the bank's size and to the diversity and complexity of operations. Further, there should be appropriate controls as evidenced by effective policies, procedures and practices, audit, and training.

For banks with total assets of $10 billion or more, regulatory responsibility for assessing compliance with many consumer compliance laws and regulations rests with the Consumer Financial Protection Bureau (CFPB). The OCC and CFPB each have authority to evaluate potential unfair or deceptive acts or practices in these banks. The CFPB also has authority to evaluate potential abusive practices in banks with total assets of $10 billion or more.

Examination Procedures

This booklet contains expanded procedures for examining specialized activities or specific products or services that warrant extra attention beyond the core assessment contained in the "Community Bank Supervision," "Large Bank Supervision," and "Federal Branches and Agencies Supervision" booklets of the *Comptroller's Handbook*. Examiners determine which expanded procedures to use, if any, during examination planning or after drawing preliminary conclusions during the core assessment phase.

Scope

The scope procedures are designed to help examiners tailor the examination to each bank's risk profile and determine the scope of the installment lending examination. This determination should consider work performed by internal and external auditors and other independent risk control functions and by other examiners on related areas. Examiners need to perform only those objectives and steps that are relevant to the scope of the examination as determined by the following objective. Seldom will every objective or step of the expanded procedures be necessary.

This booklet provides two sets of procedures: primary and supplemental.

The "Primary Examination Procedures" section of this booklet discusses the steps necessary for a comprehensive installment lending examination in smaller or less complex operations and serves as the base installment lending procedures for larger or more complex operations.

The "Supplemental Examination Procedures" section of this booklet discusses when it is necessary to expand the scope of the review. For example, it may be necessary to supplement primary procedures when a bank offers new or significantly changed products, when a particular concern exists, or when examining larger, more complex operations. The supplemental examination procedures are grouped by functional and product-specific areas.

Objective: To determine the scope of the examination of installment lending and identify examination objectives and activities necessary to meet the needs of the supervisory strategy for the bank.

1. Review the following sources of information and note any previously identified problems related to installment lending that require follow-up:

    - Supervisory strategy
    - Examiner-in-charge's (EIC) scope memorandum
    - Previous reports of examination and work papers
    - Internal and external audit reports and work papers
    - Bank management's responses to previous reports of examination and audit reports
    - Customer complaints and litigation

2. Obtain the results of such reports as Canary.

3. Using the Financial Institution Data Retrieval System (FINDRS), obtain and review relevant installment lending-related call report data. Such data may include balances, unfunded commitments, losses, recoveries, early- and late-stage delinquencies, and nonaccrual. FINDRS also includes data on the volume of capitalized fees in total reported balances, as well as information on reserves for capitalized fees and finance charges included in the ALLL or separate valuation allowance.

4. Obtain and review policies, procedures, and reports bank management uses to supervise installment lending, including internal risk assessments.

5. In discussions with bank management, determine whether there have been any significant changes (for example, in policies, processes, personnel, control systems, products, volumes, markets, and geographies) since the prior installment lending examination.

6. Based on an analysis of information obtained in the previous steps, as well as input from the EIC, determine the scope and objectives of the installment lending examination.

7. In preparing for the installment lending examination, create a request letter as directed by the EIC (refer to appendix B, “Sample Request Letter”).

8. Select from the following primary and supplemental examination procedures the necessary steps to meet examination objectives and the supervisory strategy.

Primary Examination Procedures

These procedures are designed to help examiners to assess the bank's exposure to retail credit risk relating to its installment lending activities and to identify significant changes in the bank's performance, products, or markets. These procedures provide examiners with necessary steps for conducting a comprehensive installment lending examination in small or less complex operations. These procedures also serve as baseline installment lending procedures for larger, more complex operations.

Depending on the size, complexity, and risk profile of the bank's installment lending portfolio, the primary procedures may provide examiners sufficient information to reach conclusions regarding the safety and soundness of the bank's installment lending activities. The primary procedures may also indicate the need for a more extensive review of all or parts of a bank's installment lending activities (e.g., significant changes, growth, deteriorating performance, higher-risk products, or complex operations).

Expanding the scope of the review may be necessary in cases in which the bank offers new or significantly changed products or a particular concern exists, or in larger, more complex operations. In these situations, examiners should select the appropriate supplemental examination procedures to augment the primary procedures. The supplemental procedures are grouped by functional and product-specific areas. Examiners are also encouraged to refer to other *Comptroller's Handbook* booklets, including "Community Bank Supervision," "Large Bank Supervision," "Allowance for Loan and Lease Losses," "Concentrations of Credit," "Internal and External Audits," "Internal Control," "Lease Financing," "Loan Portfolio Management," and "Rating Credit Risk."

Objective: To assess the level of risk, evaluate the quality of risk management, and determine the aggregate level and direction of risk of the bank's installment lending activities.

Examiners use the following procedures to assess the level and direction of credit, operational, compliance, strategic, and reputation risk in the installment lending portfolio.

While reviewing installment lending activities, examiners should remain alert for lending practices and product terms that could indicate discriminatory, unfair, deceptive, abusive, or predatory concerns.

Note: Examiners are encouraged to use the National Credit Tool 2 (NCT2), standard retail reports, and other NCT2 capabilities (e.g., custom reports and sampling) to assist in the retail credit review.

1. Review the scope, conclusions, and work papers from previous supervisory activities. Determine the adequacy and timeliness of management's response to the issues identified and whether any findings or issues require follow-up.

2. Review relevant reports issued by internal and external audit, QC, loan review, risk management, and compliance management since the prior supervisory activity.

Determine the adequacy and timeliness of management's responses to the issues identified and whether any findings or issues require follow-up. Request work papers, if warranted.

3. Review the minutes of retail credit-related committee meetings conducted since the prior supervisory activity.

4. Obtain copies of complaints reported to the OCC's Customer Assistance Group and bank customer complaint logs and evaluate the information for significant issues and trends. (**Note:** Complaints serve as a valuable early warning indicator for compliance, credit, and operational issues, including discriminatory, unfair, deceptive, abusive, or predatory practices.)

5. Determine whether there is any litigation, either filed or anticipated, associated with the bank's installment lending activities and the expected cost or other implications.

6. If this is an examination of an FSA, determine whether the portfolio is within the investment limits (35 percent of assets when aggregated with the FSA's commercial paper and corporate debt securities; the FSA may invest amounts in excess of 30 percent of assets only in loans it makes directly) prescribed by the Home Owners' Loan Act.

7. Determine whether the bank offers debt suspension or cancellation (debt waiver) products. If so, ensure compliance with 12 CFR 37, "Debt Cancellation Contracts and Debt Suspension Agreements," and, if program volume is significant, complete the "Debt Suspension and Cancellation" section of this booklet's "Supplemental Examination Procedures." (**Note:** FSAs are not subject to 12 CFR 37 but should have appropriate risk management processes for these products.)

   Note: To fully assess retail credit portfolio performance, identify debt waiver penetration and benefit activation rates early in the examination. Accounts generally show as current while on benefits, but portfolio analysis should recognize that these customers are not actually performing, which may indicate a higher risk profile.

8. Develop an initial assessment of the quality and performance of the bank's installment loan portfolio and product segments using portfolio reports, risk management analyses, and the Uniform Bank Performance Report. Analysis of FINDRS data may also assist in this initial assessment. Consider

   - growth.
   - portfolio mix and changes.
   - significance of the portfolio and each of the installment loan products in terms of the total installment portfolio, total loans, total assets, and capital.
   - credit performance.
   - contribution to earnings and income composition (e.g., interest and fees).

Note: If the bank securitizes assets, also analyze data on a managed basis. Coordinate findings and conclusions with the examiner(s) assigned to review securitizations throughout the examination.

9. Discuss with management changes made since the prior supervisory activity or changes planned for installment loan products or operations, including

   - growth overall and in individual products.
   - board's risk appetite.
   - portfolio product mix.
   - new products.
   - terms on existing products.
   - marketing or acquisition channels (e.g., direct, mail, telemarketing, Internet, and third-party originators).
   - expansion into new markets and trade areas.
   - new or expanded third-party loan generation or servicing arrangements.
   - underwriting, risk selection criteria, and portfolio quality.
   - monitoring and risk management processes.
   - models used to underwrite or manage the portfolio, if any.
   - loan systems, including underwriting, servicing, and collection platforms.

   Note: Examiners should understand how management assesses the effects of changes on profitability and the risk profile and incorporates the effects of changes into the planning and risk management processes.

   Also, discuss management's perception of the competition and whether the bank could remain successful in its market without changes. Determine the extent to which the changes made or proposed were in response to the competitive environment, and the reasonableness of, and analytical support for, those changes.

10. Evaluate management and the planning process. Specifically,

    - determine whether installment lending objectives are consistent with the bank's strategic plan and whether the objectives are reasonable in light of the bank's resources, expertise, product offerings, and competitive environment.
    - determine whether marketing plans and budgets are consistent with the objectives and the bank's strategic plan.
    - evaluate the adequacy of the planning process (growth, financial, and product-related), including the adequacy and timeliness of revisions when warranted by portfolio performance and new developments.
    - determine the board's risk appetite with respect to risk and return objectives (e.g., return on assets, return on equity, or return on investment) or credit performance hurdles (e.g., delinquency, credit loss, or risk score tolerances).
    - assess the qualifications, expertise, and staffing levels of management and staff in view of existing and planned lending activities.

11. Review and assess the adequacy of the bank's policies, procedures, and practices. Specifically,

    - determine whether consumer loan policies are approved by the board at inception, informed by the board's risk appetite, and included in annual policy reviews thereafter.
    - identify significant changes in underwriting criteria and terms, how credit scoring models are used, account management activities, and collection practices and policies. Specifically,
      - determine the effect of those changes on the portfolio and its performance.
      - determine whether underwriting policies provide appropriate guidance on assessing whether the borrower's capacity to repay the loan is based on a consideration of the borrower's income, financial resources, and debt service obligations.
      - determine whether the underwriting policies provide appropriate guidance on permissible collateral and on collateral valuation guidelines and methodologies.
    - if the bank uses credit scoring (e.g., bureau, pooled, or custom)
      - determine how the bank ensures that the model in use is appropriate for its target population and product offering.
      - assess the reasonableness of the process used to establish cutoffs, and determine whether management changed the cutoffs between examinations and if so the implications for portfolio quality and performance.
      - determine whether the policy provides for model monitoring and validation.
      - determine the level of scorecard overrides. If either high- and/or low-side overrides are deemed excessive, additional scrutiny is likely warranted.
    - determine how policies and changes are communicated to staff, and assess the adequacy of the process.
    - evaluate the bank's process for establishing policy exception criteria and limits, and for monitoring and approving underwriting policy exceptions (e.g., underwriting standards, loan terms, score overrides, and collateral documentation).
    - determine the control processes to track and monitor policy adherence (e.g., QC, MIS reports, loan review, and audit), and assess the adequacy of those processes.
    - if the bank uses third-party vendors, including brokers and dealers, for services such as loan origination or collection, determine
      - how policies are communicated to the vendors.
      - the adequacy of the processes for monitoring and reporting policy adherence and performance.
    - determine whether the bank's policies and procedures, including those for third-party vendors, provide adequate guidance to avoid discriminatory, unfair, deceptive,

predatory, and abusive lending practices[42] (e.g., lending predominantly on the value of collateral rather than the borrower's ability to service the debt, some high-cost loans, and misleading disclosures).

Document findings and draw conclusions from the review of the bank's installment lending policies. Examiner conclusions on the quality of installment lending underwriting policy standards should be used to complete the appropriate Credit Underwriting Assessment in Examiner View. (Updated June 16, 2016)

12. Evaluate the condition and risk profile of the portfolio and individual products by reviewing historical trends and current levels of key performance indicators. Such indicators include, but are not limited to, loan balances, delinquencies, losses, recoveries, and profitability. Focus primarily on dollar balance percentages, but also consider number of account percentages. Review performance indicators for

    - major products, sub-products, portfolio segments, acquisition channels, and acquired portfolios.
    - third-party originators, including brokers and dealers.
    - internal performance indicator hurdles and metrics. Compare actual performance indicators with internally established objectives.
    - the banking industry and peers, as available (e.g., American Bankers Association, Consumer Bankers Association, Risk Management Association, and securitization research). Compare industry indicators with the bank's performance.

    In addition to coincident analysis,[43] consider performing vintage analysis,[44] especially if underwriting criteria, loan terms, or economic conditions have changed, and lagged analysis[45] if the portfolio exhibits significant growth. If the bank keeps a well-maintained chronology log,[46] the log should prove useful in determining the causes of variances.

13. Review new account application volumes and approval and booking rates to assess portfolio growth. In addition, review new account metrics to determine the composition

[42] For more information, refer to the "Fair Lending" booklet of the *Comptroller's Handbook* and OCC Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices"; OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices"; and OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans."

[43] Coincident analysis relies on end-of-period reported performance, e.g., delinquencies or losses in relation to total outstandings of the same date.

[44] Vintage analysis groups loans by origination time period (e.g., quarter) for analysis purposes. Performance trends are tracked for each vintage and compared to other vintages for similar time on book.

[45] Lagged analysis minimizes the effect of growth by using the current balance of the item of interest as the numerator (e.g., loans past due 30 days or more) and the outstanding balance of the portfolio being measured for some earlier date as the denominator. This earlier date is usually at least six months before the date of the information used in the numerator.

[46] The chronology log is a sequential record of internal and external events relevant to the credit function.

and quality of accounts currently being booked. Compare the quality of recent account bookings with that of accounts booked in the past. Metrics evaluated should include credit score distributions (if used), price tiers, LTV or advance rate ratios, debt-to-income ratios, geographic distribution, override volume, and credit policy exceptions.

14. Evaluate the expected performance of the portfolio and the individual products through analysis of management reports, portfolio segmentation, and discussions with management. Specifically, review

    - score distributions and trends for accounts over time, evaluating scores at application (e.g., application score and bureau score), refreshed bureau scores, and behavior scores.
    - delinquencies and losses by credit score range for each major scoring model, and whether there has been any deterioration of the good-to-bad odds.
    - trends in advance rates and the effect on performance and loss severity.
    - loan growth sources (e.g., branch, region, loan officer, and product channel, such as direct, indirect, telemarketing, direct mail, or Internet) and differences in performance by source.
    - levels and trends of policy and documentation exceptions and the performance of accounts with exceptions versus the performance of the portfolio overall.
    - levels and trends of repossessions.
    - volumes and trends of first and early payment defaults.
    - volumes and trends of prepayment (closed-end).
    - management's loss forecasts.

15. Review collection department reports and activities to determine the implications for credit quality. (**Note:** Several of the procedures already performed also reflect collections activities (e.g., review of delinquencies and losses).)

    - Review roll-rate[47] reports overall and by product, evaluate trends, and, if peer group performance is available, compare roll-rates.
    - Review the criteria, volume, performance, and trends for forbearance programs, as well as for extended, deferred, renewed, and rewritten accounts.
    - Determine the reasonableness of the bank's collection strategies and the adequacy and timeliness of the processes for making revisions.
    - Determine whether the bank uses third parties in collections processes or sells charged-off debt to third parties. If so, assess the adequacy of risk management around this process.
    - Review the loss forecasting process and determine whether it is reasonable and reliable.
    - Review the level and trend of customer complaints as a potential indicator for unfair or deceptive acts or practices.

[47] Roll-rates measure the movement of accounts and balances from one payment status to another (e.g., percentage of accounts or dollars that were current last month rolling to 30 days past due this month).

16. Assess the adequacy of MIS and reports with respect to providing management the necessary information to monitor and manage all aspects of installment lending. Determine whether

    - adequate processes exist to ensure data integrity and report accuracy and whether balances and trends included in management's reports reconcile to the bank's general ledger and the call report.
    - various department reports are consistent, i.e., the reports show the same numbers for the same categories and time periods regardless of the unit generating the report.
    - descriptions of key management reports are maintained and updated.
    - reports are produced to track volume and performance by product, channel, and marketing initiative and to support any test with implications for credit quality or performance (e.g., pricing, advance rates). This reporting process should be fully operational before the bank offers new products or initiates tests to accurately monitor performance from inception.
    - MIS and reports are available to clearly track volumes, performance, and trends for all types of forbearance or workout programs, as well as activities such as extensions, deferrals, renewals, and rewrites.
    - reports are clearly labeled and dated.

17. Determine whether the amount of the ALLL is appropriate and whether the method of calculating the ALLL is in compliance with GAAP. Determine whether management routinely analyzes the portfolio to identify instances when the performance of a product or some other segment (e.g., workout programs) varies significantly from the performance of the portfolio overall, and that such differences are adequately incorporated into the ALLL analysis. Refer to the "Allowance for Loan and Lease Losses" booklet of the *Comptroller's Handbook* for guidance, and specifically consider

    - whether estimates and assumptions are documented and supported consistent with FFIEC guidance (refer to OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses: Guidance and Frequently Asked Questions on the ALLL").
    - credit quality, including any changes to underwriting, account management, or collections that could affect performance and credit losses at the financial statement date.
    - historical credit performance and trends (e.g., delinquency roll-rates and flow-to-loss) overall, by product, and by vintage within products.
    - level, trends, and performance of subprime and other higher-risk populations.
    - level, trends, and performance of cure or workout programs, including re-agings, extensions, deferrals, renewals, modifications, and rewrites.
    - levels and trends of bankruptcies and the performance of bankruptcy accounts that remain on the bank's books (including accounts that have been reaffirmed and those that have not).
    - charge-off practices and consistency with OCC Bulletin 2000-20.
    - whether management provides for accrued interest and fees deemed uncollectible in the ALLL or in a separate reserve.
    - economic conditions and trends.

18. Validate the preliminary risk assessment conclusions by conducting on-site transaction testing. The purpose of working these samples includes

    - verifying adherence to bank policies.
    - determining whether the bank maintains adequate documentation of analysis and decisions.
    - verifying whether MIS reports accurately capture exception information.
    - determining whether practices exist that are inconsistent with bank policy or are not adequately depicted in existing management reports.

    The sample selected should be sufficient in size to reach a supportable conclusion.

    Examiners conducting testing should remain alert for potentially discriminatory, unfair, deceptive, abusive, or predatory lending practices (e.g., lending predominantly on the value of collateral rather than the borrower's ability to service the debt). If weaknesses or concerns are found, consult the bank's EIC or compliance examiner.

    For each product being reviewed,

    - sample recently approved accounts to assess adherence to underwriting policy. If the bank uses credit scoring, select two samples: one from accounts not automatically approved (e.g., judgmental decision involved even if credit scoring is used as a tool) and one from automatically approved accounts.
    - sample recent "override" loans, i.e., exceptions to normal underwriting standards, to evaluate the adequacy and consistency of the judgmental decision process.
    - sample loans that were 60 days or more delinquent two months ago and are now current to determine whether the customer cured the delinquency through payments or whether the account was extended or re-aged. If the latter, determine whether the action was consistent with bank policy and with the guidance set forth in OCC Bulletin 2000-20.
    - sample loans that were recently extended, deferred, renewed, or rewritten for compliance with bank policy and reasonableness. Compliance with bank policy should be judged against the bank's normal underwriting guidelines with respect to LTV, amortization period, debt or payment limitations, and pricing. Any forbearance programs with the potential to simply defer losses to a future period should be highly scrutinized.
    - sample TDR classification of troubled loans that have been restructured.
    - sample recently charged-off loans and review the borrower, payment, and collection history to determine whether the actions taken pre-charge-off were reasonable and whether the practices had the effect of deferring losses.
    - request a list of loans that have been charged off and subsequently rebooked during the last 12 months. Review the reason for the rebooked asset. Determine whether the asset was rebooked due to bank error and not in contradiction of call report guidance/instructions.

Based on the results of transactional testing and the severity of concerns identified, determine whether the sample should be expanded.

(**Note:** Refer to appendix A, "Transaction Testing," of this booklet for more testing suggestions.)

Assess the quality and direction of underwriting practices for selected loans originated, renewed, or restructured since the previous examination. Review the more recent loan originations, if possible. (Updated June 16, 2016)

- Midsize and Community Bank Supervision examiners generally use the most recent version of the National Credit Tool to perform the Credit Underwriting Assessment for each transaction sampled, unless use of the tool is appropriately waived. (Updated June 16, 2016)
- Conclusions from the individual transaction reviews should be used to support the assessment of the quality of underwriting practices and the direction of underwriting practices in the appropriate Credit Underwriting Assessment in Examiner View. (Updated June 16, 2016)

19. Complete the "RCCP Checklist" in appendix C to determine the bank's implementation of the guidance in OCC Bulletin 2000-20.

20. If the bank is involved in higher-risk retail lending, regardless of whether formally designated as subprime, determine whether management realistically identifies the level of risk assumed and that the ALLL and capital provide sufficient support for the activity.

    In addition, OCC Bulletins 1999-10 and 1999-15[48] provide guidance for the bank's policies and procedures. If the bank has a targeted subprime program with volume exceeding 25 percent of tier 1 capital, review the program for consistency with OCC Bulletin 2001-6.[49]

21. If the bank relies on third-party vendors for significant functions, review consistency with OCC Bulletin 2013-29. If further review is warranted, refer to the "Third-Party Management" section of the booklet's "Supplemental Examination Procedures."

22. Determine the effectiveness of the loan review process for installment lending. Determine the scope and frequency of the reviews and whether loan review provides a risk assessment of the quality of risk management and quantity of risk. (**Note:** For more information, refer to the loan review section of this booklet's "Supplemental Examination Procedures" and "Control Functions" sections)

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[48] Refer to footnote 37.

[49] Banks may not have a "targeted subprime program" yet have a concentration in subprime lending. Management that does not recognize the bank's subprime exposure should be a safety and soundness concern. In addition, if the bank only has a prime program, management should monitor adverse selection activity that could result in an increase in subprime loans that represent a concentration in capital.

23. QA/QC are also very important control points and need to be evaluated. QA is the first line of review and QC is the second line of review (banks may use the terms interchangeably). In some firms large and small, QA does serve as their retail loan/credit review process as well.

24. Review copies of the materials provided to the board and relevant senior management committees to determine whether the board and senior management are adequately apprised of the condition of the installment loan portfolio and of significant decisions with implications for the quality and performance of the portfolio.

25. Fully document findings, conclusions, and recommendations in a memorandum for review and approval by the loan portfolio management examiner or the EIC. Reach a conclusion with respect to the quality of risk management, the quantity of risk, and the aggregate level and direction of risk, and include all necessary support. To accomplish these ends, complete the following procedures:

    - Determine whether further work needs to be completed in the installment lending area to fully assess credit risk or other risks. If so, refer to the appropriate expanded procedures.
    - Provide criticized and classified asset totals to the LPM examiner or the EIC. In addition to the delinquency-based classifications outlined in OCC Bulletin 2000-20, consider bankruptcies, workout programs, repossessed assets, and any other segments that meet the criticized and classified definitions.
    - Provide findings and conclusions in the Credit Underwriting Assessment in Examiner View. (Updated June 16, 2016)
    - Provide conclusions to the examiner responsible for assessing earnings and capital adequacy.
    - If the bank securitizes assets, provide conclusions and supporting information about credit quality to the examiner assigned to review securitizations.
    - If significant violations of laws, rulings, or regulations are noted, prepare write-ups for inclusion in the report of examination.
    - Prepare a recommended supervisory strategy for the installment lending area.
    - Document findings in OCC systems, as appropriate.

Supplemental Examination Procedures

The supplemental procedures are organized by functional and product-specific areas. These procedures are targeted to larger, more complex operations, as well as to smaller banks whose condition requires more comprehensive review.

In addition, the appendixes provide additional tools examiners can use to plan and conduct installment lending examinations.

- **Transaction testing (appendix A):** A description of common testing methods used during installment lending examinations.
- **Sample request letter (appendix B):** A sample request letter tailored to this booklet's "Primary Examination Procedures" but also applicable to the "Supplemental Examination Procedures."
- **Uniform Retail Credit Classification and Account Management Policy checklist (appendix C):** An examination tool to test consistency with OCC Bulletin 2000-20.
- **Debt suspension agreement and debt cancellation contract forms and disclosure worksheet (national bank) (appendix D):** An examination tool to assist in assessing national banks' compliance with 12 CFR 37 disclosure requirements. [50]
- **Debt suspension and debt cancellation product information questionnaire and worksheet (appendix E):** An examination tool to assist in documenting a bank's debt suspension and cancellation practices and product characteristics.
- **Loss forecasting tools (appendix F):** A description of roll-rate forecasting and other forecasting techniques.
- **Credit scoring and development of scoring models (appendix G):** A discussion of statistical methods used to construct credit scoring models (e.g., multiple linear regression, logit and probit, discriminant analysis, and general linear models).
- **Glossary (appendix H).**
- **Abbreviations (appendix I).**

Note: Examiners should select the appropriate procedures necessary to assess the condition and risk of the bank's installment lending products and operations.

Management and Management Planning

Conclusion: Based on the responses to procedures, the quality of risk management for the bank's management activities is (strong, satisfactory, insufficient, or weak).

Objective: To assess the effectiveness of the overall planning process and the bank's capacity, including management expertise and staffing, with respect to installment loan products offered and planned to be offered.

[50] Refer to footnote 36.

1. Discuss the bank's planning process with management and determine whether the process is formal or informal. The applicability of the following steps depends on the size and complexity of the bank and the process.

2. Determine whether the installment lending component of the strategic plan is realistic and prudent given the current competitive, economic, and legal environments and the bank's capacity and level of expertise.

   - Assess the strategy and any supporting documents.
   - Determine whether the installment lending objectives are consistent with the bank's strategic plan.
   - Determine whether marketing plans and budgets are consistent with the objectives and the bank's strategic plan.
   - Review the competitive analysis (bank prepared) and available industry information.
   - Review the analysis of economic, legal, and other external factors.
   - Review the assumptions used to develop the plan and assess the reasonableness of the assumptions.
   - Review the organizational structure and management expertise in key positions and determine whether they are adequate to execute the plan (incorporating conclusions regarding capacity).

3. Determine whether the strategic plan establishes realistic risk appetite.

   - Determine whether the plan incorporates risk parameters for growth, credit quality, concentrations, income, and capital.
   - Determine whether the plan addresses risk-layering.
   - Determine how the limits were established (i.e., assumptions used).
   - Assess the limits for reasonableness.
   - Discuss with management the key risks and obstacles (strengths, weaknesses, opportunities, and challenges) to achieving the plan.

4. Assess the adequacy of the bank's process for tracking performance against the plan.

   - Determine the process to track actual performance against the plan.
   - Assess the adequacy of the process, including
     - timeliness, accuracy, and detail of reports.
     - frequency of reports.
     - report distribution, ensuring that results are provided to senior management and the board.
   - Assess the bank's process for revising the plan and supporting operating plans to reflect current information and trends.

5. Determine whether management adequately considers the economic cycle in the planning process.

- If the bank does not incorporate economic cycle information, determine whether planning is appropriate given the bank's circumstances (e.g., the size and complexity of the operation or market).
- Determine who develops the scenarios (e.g., finance, marketing, or risk management) and obtain copies of the best-case, worst-case, and most likely scenarios.
- Review the assumptions used, the reasonableness of the assumptions, and the frequency of analyses.
- Determine whether the bank uses stress testing. If it does not, discuss with management how the portfolio would withstand an economic downturn. For example, how does the bank ensure that underwriting standards are maintained at levels sufficient to withstand economic cycles?
- Determine how management uses economic cycle information in the planning process.
- If warranted, recommend that the bank adopt stress testing.

6. Determine whether the bank has sufficient management expertise and whether management is held accountable for executing the plan.

    - Using the organization chart, discuss with senior management the backgrounds and responsibilities of key managers. Confirm understanding of those roles with the key managers.
    - Obtain the criteria for key management compensation programs and position evaluations or performance elements. Determine whether the criteria include appropriate qualitative (risk) considerations in addition to quantitative (growth or marketing) goals and whether the goals are consistent with the bank's plan. In addition, review key managers' performance-based compensation for the most recent evaluation period to determine whether managers are held accountable for meeting agreed-upon objectives.
    - Incorporate the results from the other examination objectives in reaching conclusions regarding management.

7. Determine whether the operational capacity, infrastructure, and MIS are sufficient to support and execute the bank's strategic plan.

    - Determine whether key operations and systems managers are adequately involved in the planning process.
    - Discuss capacity planning with management (e.g., facilities, systems, staffing, and training).
    - If available, obtain and review the most recent capacity studies for staffing (including underwriting, collections, and control functions), facilities, systems, and technology. Assess adequacy and identify the implications for plan execution. Assess management's response to study findings and the potential impact on current plans.
    - Review the retail organizational structure and note any significant changes in senior management or staffing levels, including turnover trends for significant functional areas.

- Review the compensation plans for the various functional areas (e.g., sales/originations and collections) and assess the reasonableness of those plans.
- Incorporate the results from the other examiners assigned to the review and determine whether any capacity, infrastructure, or MIS issues or problems have been revealed.

8. Determine whether management has a process for establishing specific performance goals for items such as loan growth, policy overrides, credit performance, and profitability for the installment loan portfolio as a whole and segmented by product. Determine whether management effectively tracks actual performance against these goals.

9. Determine whether management has appropriately considered ALLL and capital needs and support in the plan.

10. Develop conclusions about the effectiveness of the overall planning process and the bank's capacity, including management expertise and staffing, with respect to installment loan products offered and planned to be offered.

Underwriting, Credit Scoring/Modeling, and Product Marketing

Conclusion: Based on the responses to procedures, the quality of risk management for the bank's installment underwriting, credit scoring/modeling and product marketing activities is (strong, satisfactory, insufficient, or weak).

Objective: To assess the quality of the bank's new installment loans and any changes from past underwriting, determine the adequacy of and adherence to the board's credit risk appetite statement, lending policies and procedures, and gain a thorough understanding of the processes employed in account origination. To determine whether marketing activities are consistent with the bank's business plans, strategic plans, and risk appetite objectives and whether the bank puts appropriate controls and systems before rolling out new products or new product marketing initiatives.

Underwriting

1. Ascertain and evaluate the types of installment lending and leasing the bank engages in and evaluate the reasonableness of the following:

   - Loan products offered and planned.
   - Underwriting standards and terms.
   - Degree of innovation (e.g., new terms, products, and markets).
   - Markets served and economic conditions.
   - Competitive environment.
   - Volume and proportion of loan portfolio (managed and on book), by product.
   - Level of participation in high-risk or subprime lending.
   - Degree of potential risk-layering.

- Pricing and profitability.
- Documentation standards.
- Types of marketing and account acquisition channels.
- Historical and planned growth.
- Securitization activities.

Note: When examiners evaluate lending activities, they should remain alert for practices and product terms that could be considered discriminatory, unfair, deceptive, abusive, or predatory.

2. Review new account metrics to determine the composition and quality of accounts currently being booked and the adequacy of MIS to track new loan volume. Compare the quality of recent vintages to the quality of prior vintages. Metrics evaluated, by product, should include

   - application volume and approval and booking rates.
   - distribution of credit scores, if used, by applications approved and booked.
   - price tiers and fees.
   - LTV or advance rate ratios.
   - average loan amount.
   - debt-to-income or payment-to-income ratios.
   - geographic distribution.
   - override volume.
   - credit policy exceptions.

3. Obtain an overview of the origination process and the steps involved, including application receipt and processing, underwriting, and collateral valuation, perfection, and documentation. When describing the process in the work papers, document the following:

   - Which aspects of the underwriting process are automated versus manual.
   - Use of credit scoring models (e.g., types of models, history of model use, monitoring, and validation).
   - Differences in the underwriting processes arising from the application channel (e.g., direct mail, telemarketing, Internet, and broker/dealer).
   - How collateral is valued, security interests are perfected, who is responsible, and how filings are tracked.
   - Whether insurance coverage is verified and whether it is monitored thereafter.

4. Determine how management evaluates underwriter performance, including monitoring new loan MIS, subsequent performance MIS, and transaction testing completed by the manager, QC, and loan review.

5. If the bank uses credit scoring in the underwriting process, assess the mix of automated and judgmentally approved loans. Also, refer to the credit scoring/modeling steps in this section.

6. For banks that lend in multiple geographic areas or states, confirm that management performs periodic bureau preference analyses to determine optimal credit bureaus for different states or localities.

7. Obtain a copy of the bank's lending policies and procedures. Assess the adequacy and soundness of the policies and procedures, focusing on the main criteria used in the decision-making process and, if applicable, the verification processes used to confirm application and transaction information. Evaluate

   - permissible types of loans.
   - lending authority and limits and the exception approval process.
   - limits on concentrations of credit (e.g., product, geographic, broker, dealer, and score band).
   - credit underwriting criteria, including measurements of the borrower's capacity to repay the loan (e.g., debt-to-income and payment-to-income ratios) and treatment of derogatory credit bureau items.
   - credit scorecard cutoffs and tolerances for overrides.
   - borrower credit grade definitions (e.g., A, B, and C).
   - repayment terms (e.g., duration, amortization schedule, and pricing).
   - maximum amount financed and LTV ratios, including allowable options and verification of options and add-ons, as applicable.
   - permissible collateral (e.g., furniture, automobiles, or service contracts) and lien perfection requirements.
   - collateral valuation guidelines and methodologies.
   - exception and override processes, criteria, and tracking.

   Document findings and draw conclusions from the review of the bank's installment lending and leasing policies. Examiner conclusions on the quality of installment lending underwriting standards should be used to complete the appropriate Credit Underwriting Assessment in Examiner View. (Updated June 16, 2016)

8. Determine whether the policies and procedures provide adequate guidance to avoid discriminatory, unfair, deceptive, abusive, and predatory lending practices. Policies and procedures should address loans involving features or actions that have been associated with discriminatory, unfair, deceptive, abusive, or predatory lending practices, including

   - lending predominantly on the liquidation value of collateral rather than the borrower's ability to service the debt.
   - refinancing loans frequently.
   - requiring single-premium credit life insurance or similar products.
   - using negative amortization.
   - requiring balloon payments in short-term transactions.
   - charging prepayment penalties in the later years of a loan.
   - charging high financing points, fees, and penalties.
   - increasing interest rates upon default.

- inserting mandatory arbitration clauses.

Additionally, policies and procedures should provide adequate guidance to ensure that loans offered to borrowers are consistent with their needs, objectives, and financial condition. If weaknesses or concerns are found, consult the bank's EIC or compliance examiner.

Note: For more information, refer to the "Fair Lending" booklet of the *Comptroller's Handbook* and OCC Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices"; OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices"; and OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans." Also refer to OCC Bulletin 2013-40, "Deposit Advance Products: Final Supervisory Guidance."

9. Assess the adequacy of the process for changing underwriting standards. Review all changes in standards since the last examination and determine the changes' effect on the quality of the portfolio.

   - Review analyses and documentation supporting recent changes to underwriting criteria and score cutoffs.
   - Discuss reasons for changes (if not readily apparent) with bank management and determine whether there has been a shift in the credit risk appetite.
   - Determine whether all affected functional areas provide input to underwriting changes.
   - Verify that management maintains a chronology of significant changes to underwriting standards.

   If applicable, document findings of any significant changes to the bank's installment lending and leasing policies. Draw conclusions on the quality of installment lending underwriting standards resulting from changes to complete the appropriate Credit Underwriting Assessment in Examiner View. (Updated June 16, 2016)

10. Determine the adequacy of the bank's verification procedures and verify that, residence, employment, income, and collateral values are routinely confirmed.

11. Evaluate credit policy exception and scorecard override limits and tracking/reporting. Determine whether

    - volumes conform to policy limits and whether those limits are reasonable.
    - management tracks the volumes and trends of policy exceptions by type and tracks overrides separately and by reason code.
    - management tracks the performance (i.e., delinquencies and losses) of these accounts over time and by type and compares the performance to that of the overall portfolio.

- as warranted, management responds appropriately to the levels of overrides and exceptions, adjusting underwriting policies and exception limits or providing additional underwriter training accordingly.
- management appropriately identifies the effects of the levels of exceptions and overrides and the performance of affected accounts on the quantity and direction of credit risk.

12. Determine whether the volume of collateral exceptions is reasonable and tracked appropriately and whether the impact of the exceptions is assessed.

13. Determine how management tracks lapsed insurance coverage and addresses coverage lapses (e.g., contacting borrowers to reinstate insurance, requiring force-placed insurance, or maintaining third-party insurance coverage on the portfolio). If force-placed insurance is used, determine whether management tracks unpaid premiums.

14. Select and work appropriate samples to determine credit quality; verify adherence to bank underwriting policies, including verification procedures; assess the adequacy of analysis and decision documentation; determine whether MIS reports accurately capture exception information; and determine whether practices exist that are inconsistent with bank policy or that are not adequately depicted in existing management reports (e.g., risk-layering). For each significant product type, do the following:

    - Sample recently approved accounts to assess adherence to underwriting policy. If the bank uses credit scoring, select two samples—one sample from accounts not automatically approved (e.g., judgmental decision involved even if credit scoring is used as a tool) and one sample from accounts automatically approved. Ensure that the sample includes loans originated from each significant marketing channel and, if warranted, consider expanding the sample to more thoroughly test specific channels.
    - Sample recently approved accounts that represent exceptions to underwriting policy to determine whether credit decisions are consistent and whether the analysis and other support for them is adequate.
    - If the bank uses brokers, dealers, or other third-party originators, sample recently approved loans from each significant originator, with emphasis on loans made with exceptions, if any. Assess adherence to bank policy, consistency of decision making, and adequacy of supporting documentation.

    Use NCT2, the bank's credit files, account origination systems, and MIS reports to create a worksheet summarizing information from the sample. The worksheet should be tailored to fit the product and the bank's underwriting criteria but generally includes the following information:

    - **Account data:** Name, account number, origination date, employment information, and time at residence.
    - **Underwriting terms:** Credit score (bureau, pooled, or custom), debt-to-income, LTV, pricing, loan term, and payment amount.

- **Collateral information:** Invoice price and options (automobiles), appraised value and lien information (real estate), and insurance verification.
- **Underwriting policy exceptions and score overrides:** Indicate whether identified by the bank or the examiner.

  If prepared properly, the worksheet facilitates examiner analysis and provides a sound foundation for reaching conclusions about the adequacy of the bank's policy and adherence thereto.

15. Document findings to support quality of installment underwriting practices and direction of underwriting practices for selected loans in the Credit Underwriting Assessment using the appropriate version of NCT2. Based on the results of the testing and the severity of the concerns identified, determine whether the samples should be expanded. Refer to appendix A, "Transaction Testing," for additional sample suggestions. (Updated June 16, 2016)

16. Document conclusions on quality of installment underwriting practices and direction of underwriting practices in the appropriate Credit Underwriting Assessment in Examiner View. (Updated June 16, 2016)

Credit Scoring/Modeling

Note: Refer to OCC Bulletin 1997-24 and OCC Bulletin 2011-12 for additional background and guidance in this area.

16. Assess the scorecard management process and determine the department or personnel responsible for scorecard and model development or procurement; implementation, including monitoring; and validation.

    - Obtain a model inventory to determine the models in use. The inventory should include
      - name of the model.
      - model description.
      - type (custom, generic, or behavioral).
      - date developed.
      - source (name of the vendor or in-house modeler).
      - purpose (e.g., application, response, attrition, pricing, or profitability).
      - date last validated and next scheduled validation date.
      - model rating.
      - models under development, if any.
      - management contact for each model.
    - Determine whether scorecards are used for purposes consistent with the development process/populations. If not (e.g., scorecards are applied to a different product or new geographic area), assess the ramifications and acceptability.
    - Review the most recent independent validation reports for key risk models and discuss the conclusions with risk management.

- Discuss how management uses the models to target prospects, underwrite applications, and manage the portfolio.
- Determine how management measures the ongoing performance and robustness of models (e.g., good/bad separation, bad rate analysis, and maximum delinquency ("ever bad") distribution reports).
- Review scorecard tracking reports to determine how well the models are performing. Select tracking reports for key models and determine whether model performance is stable or deteriorating and how management compensates for deteriorating efficacy.
- Determine how cutoffs are established, reviewed, and adjusted. Review the most recent cutoff analysis for key risk models.
- Determine the bank's score override policy, assess the adequacy of associated tracking, and review override volume and performance. Determine whether management segments low-side overrides by reason and tracks delinquencies or defaults by reason and override score bands, and assess the performance and trends.
- Review chronology logs to determine changes in the credit criteria or risk profile and to explain shifts in the portfolio, including volume and performance.

17. Select at least one key credit risk scoring model and fully assess the adequacy of the model management process.

    - Review the original model documentation or scorecard manual and assess management's adherence to the modeler's recommended scorecard maintenance routine.
    - Compare the population characteristics and the developmental sample performance odds with the bank's current experience.
    - Review model performance reports and assess the adequacy of management's response to the issues or trends identified. Reports reviewed may include applicant distribution, population stability, characteristic analysis (if indicated by a population shift), override tracking, and vintage delinquency and loss distribution reports.

Marketing of Products

18. Assess the structure and expertise of marketing, focusing on management, key personnel, and staffing adequacy.

19. Review the marketing plan and assess it for reasonableness given the bank's strategic plan and objectives, level of expertise, capacity (operational and financial resources), market area, and competition.

    - Determine whether the plan is based on internally or externally prepared market, economic, or profitability studies. If so, obtain and review copies of those studies.
    - Review the process for developing and implementing marketing plans, with particular attention to whether the appropriate functional areas (e.g., risk management, finance, operations, information technology (IT), legal, and compliance) are involved throughout the process.

- Assess the appropriateness of the data and assumptions used to develop marketing plans, in part through the review of MIS reports that track actual performance against marketing plans.
- Discuss with management the controls to monitor marketing plans and activities. **Note:** Before implementing any marketing initiative, including the rollout of a new product or change to an existing product, management should review all marketing materials, customer disclosures, and product features and terms to identify and address potential discriminatory, unfair, deceptive, abusive, and predatory lending practices, as well as compliance with consumer laws, regulations, and rules.
- Discuss with management any significant changes made, or planned, to account acquisition, account management, and cross-selling strategies, including changes in channels and the use of third-party vendors.

20. Assess new product development. Specifically,

- discuss with management the new product development process.
- determine whether there are written guidelines for what constitutes a new product.
- review new product proposals and plans approved since the last examination.
- determine whether the appropriate functional areas (e.g., risk management, finance, operations, IT, legal, and compliance) are involved throughout the development process to ensure that associated risks are properly identified and controlled. In addition, determine whether the constituents remain involved during implementation.
- evaluate systems planning to determine whether MIS and reporting needs are adequately researched and developed before new products are rolled out. Specifically, determine whether the systems and reports are adequate to supervise and administer new products.
- evaluate the adequacy of the review and approval processes for new products.
- determine whether management, including appropriate legal and compliance personnel, reviews marketing materials during product development and implementation to avoid deceptive or misleading advertising, terms, and disclosures.
- determine whether the planning process adequately identifies and addresses the risks, operational needs, and systems support associated with different solicitation methods and channels, including direct applications, indirect (broker/dealer), loan-by-phone, and the Internet.

21. Evaluate the adequacy of the bank's test process for new products, marketing campaigns, and other significant initiatives. Review the process to determine whether testing

- is a required step for any new products or significant marketing and account management initiatives.
- is properly approved. Senior management should approve the testing plan and should determine whether the proposed test is consistent with the bank's strategic plan and meets strategic objectives.
- requires clear descriptions of test objectives and methods (e.g., assumptions, test size and selection criteria, and duration), as well as key performance measurements and targets.

- includes a strong test and control discipline. The test should include a clean holdout group and test groups that are not subject to any significant account management or cross-selling initiatives for the duration of the test. (**Note:** Strict test group design enables management to draw more accurate performance conclusions.)
- is accorded a period of time sufficient to determine probable performance and work through any operational or other issues. When the test involves a significant departure from existing bank products or practices, test duration should probably be longer. (**Note:** Tests should run at least six months, and usually run nine or 12 months. The time frame may vary depending on the product or practice being tested.)
- is supported by appropriate MIS and reporting before implementation.
- requires a thorough and well-supported postmortem analysis in which results are presented to and approved by senior management and the board before full rollout.

22. Determine whether management assesses how underwriting standards for new products may affect credit risk and the bank's risk profile.

23. Evaluate cross-selling strategies, including the criteria used to select accounts.

24. If the bank maintains a data warehouse, determine how it is used for marketing purposes and whether it is capable of aggregating consumer loan relationships.

25. Determine the adequacy and effectiveness of the bank's controls with respect to information sharing, for both affiliates and unrelated third parties.[51]

26. Prepare profiles for each of the products offered. Address

    - product description, including any unique characteristics and a general overview of terms (including pricing), target market (credit quality and geographic), and distribution channels.
    - changes in the product characteristics since the last examination.
    - volume and trends summary, discussing growth to date and planned growth.

27. Select at least one new product introduced since the prior supervisory activity to assess the bank's planning process. Specifically, review

    - planning documents and the final approved proposal.
    - tests and analysis conducted, including performance compared to expectations.
    - MIS tracking reports.
    - available risk management, QC, and audit reviews.
    - any subsequent product modifications and the basis or documented support for those changes.
    - management review and approval documentation.
    - information presented to the board.

[51] Refer to 12 CFR 1016, "Privacy of Consumer Financial Information (Regulation P)."

28. Develop conclusions about whether marketing activities are consistent with the bank's business plans, strategic plans, and risk appetite objectives and whether appropriate controls and systems are in place before new products or marketing initiatives are rolled out.

Third-Party Originations (Includes Brokers and Dealers)

Note: Also refer to the "Third-Party Management" section of this booklet's "Supplemental Examination Procedures" for information on contracts, due diligence, and performance monitoring.

29. Determine whether the bank has underwriting guidelines, including dealer compensation, and governing contracts for purchasing loans originated by third parties and, if so, assess the reasonableness of those guidelines. Verify that the bank has the ability to reject loans that do not meet its criteria.

30. Determine the adequacy of processes, including QC, to assess whether purchased loans are consistent with the bank's underwriting criteria. Specifically, determine

    - how policies are communicated to third parties.
    - adequacy of the policy adherence, performance monitoring processes, and reporting.

31. Assess the adequacy of the bank's process for establishing relationships with brokers, dealers, and other origination sources. (**Note:** Examiners should be alert to any insider and affiliate relationships, conflicts of interest, concentrations, and the originators' ability to fulfill recourse commitments.)

    - Review the bank's due diligence process and qualification requirements.
    - Sample new and significant existing relationships and review the file documentation and agreements to determine adherence to due diligence and qualification requirements.

32. Evaluate the broker and dealer monitoring process. Determine whether

    - MIS reports provide sufficient information to track and evaluate the performance of individual brokers and dealers, including
      - volume of applications, approvals, and bookings.
      - booking quality (e.g., credit scores or grades).
      - exceptions and overrides.
      - credit performance (e.g., delinquencies, losses, first or early payment defaults, and repossessions).
      - profitability.
      - dealer compensation including discretionary pricing.
    - management performs annual or periodic reviews of brokers and dealers.
    - management maintains a broker and dealer watch list and terminates relationships that do not meet underwriting guidelines and quality standards.

33. Evaluate dealer reserve arrangements and the procedures for managing those reserves. Review the adequacy of the bank's procedures for advancing dealer differentials and for recovering advances on early payoffs and defaults.

34. Determine if the bank permits third parties pricing discretion. If pricing discretion is permitted, review the bank's risk management systems to ensure borrowers are treated consistently with the bank's loan policy. Evaluate

    - due diligence and management of third parties.
    - fair lending risk assessments or analysis.
    - secondary reviews processes including QA/QC, audit, and self-tests.

Account Management

Conclusion: Based on the responses to procedures, the quality of risk management for the bank's installment lending account management activities is (strong, satisfactory, insufficient, or weak).

Objective: To assess the effectiveness of activities and strategies used to enhance performance and increase profitability of existing, nondelinquent accounts or portfolios and determine the implications for the quality of the portfolio and the quantity and direction of risk.

(**Note:** Account management activities are used extensively in open-end lending for products such as credit cards, other unsecured lines of credit, and home equity lines. Banks should, however, actively monitor and manage existing closed-end accounts as well. Therefore, the following procedures are targeted specifically to closed-end products.)[52]

1. Determine whether bank systems are capable of aggregating the entire loan relationship by customer (multiple loan accounts by product and in total) for the purpose of customer-level account management. If so, determine the extent to which the bank uses that capability.

2. Determine whether the bank uses credit or behavioral scoring for nondelinquent account management. If so, identify the type of scoring used (e.g., refreshed bureau, behavior, or bankruptcy scores), the frequency of obtaining updated scores, and how the scores are used in the account management process.

3. If the bank does not use scoring or augments scoring, determine how management reviews the bank's account base for changes in credit quality (e.g., bureau warning screens or delinquent property tax notifications) or to identify marketing opportunities.

[52] Refer to OCC Bulletin 2000-20, "Uniform Retail Credit Classification and Account Management Policy" and open-end lending procedures found in the "Credit Card Lending" booklet and the "Residential Real Estate Lending" booklet of the *Comptroller's Handbook*.

Determine whether the process is reasonable, including any actions taken based on the reviews.

4. Review and assess the adequacy of written policies and procedures governing account management activities, including disclosure requirements. Account management activities may include

   - payment holiday programs. (Note: Payment holiday programs should be offered only to the most creditworthy customers.)
   - pay-ahead programs. (Note: Banks should limit the use of pay-ahead programs to accounts with low risk characteristics.)
   - customer service extensions and deferrals.
   - retention programs. (**Note:** Retention programs are critical to relationship management and attrition. Be alert to whether the programs are proactive or reactive, and how management measures performance.)

5. Determine the adequacy of the bank's administration of account management programs. Specifically,

   - review the adequacy of the program or strategy approval process and assess whether all interested units are appropriately represented (e.g., risk management, marketing, customer service, compliance, IT, and finance).
   - assess whether the analyses performed to support new and existing strategies are adequate and appropriately consider all possible effects of the proposed actions (e.g., the effects on credit performance, attrition and adverse retention, earnings, and compliance and reputation risks). In addition, determine whether analyses properly consider the impact of overlapping or repeat account management strategies.
   - determine whether the bank performs adequate testing of strategies that have the potential for significant impact on credit performance and earnings before full implementation.
   - ensure that the bank has developed and implemented appropriate MIS reports before initiating testing and strategies and that management regularly monitors and analyzes actual versus expected results.
   - assess the adequacy and timeliness of management's response to poorly performing strategies, as well as the actions taken when strategies perform significantly better than expected.

6. Assess the reasonableness of the bank's account management strategies, evaluating the scope and frequency of each strategy employed, the inclusion and exclusion criteria, the various strategy components and outcomes, and adherence to the approved proposals and written policies and procedures.

7. Review the policies that govern imposing and waiving late, extension, and other fees. Determine whether the policies are reasonable, applied in a nondiscriminatory manner, and the effect on performance is adequately monitored, analyzed, and addressed.

8. Based on the significance of the bank's use of account management activities, determine whether account sampling is warranted. If so, refer to the sampling procedures later in this booklet and in appendix A, "Transaction Testing."

9. Develop conclusions with respect to the effectiveness of activities and strategies used to enhance performance and profitability of existing, nondelinquent accounts or portfolios, and any implications for the quality of the portfolio and the quantity and direction of risk. Clearly document all findings.

10. Determine how the bank handles payments returned for not sufficient funds (NSF) or other reasons. Verify that accounts are moved to the appropriate delinquency status if a payment instrument does not clear.

11. Determine whether the bank renews, modifies, or rewrites existing loans to nondelinquent customers. If so, evaluate the adequacy of the process, including the policies and procedures employed and the volume, trends, and subsequent performance of those loans.

12. Assess the adequacy of the bank's process for monitoring ongoing insurance coverage and the loss payee status on collateral.

Vehicle Leases

13. Review management's process for identifying and monitoring portfolio concentrations (e.g., make, model, type, maturity, LTV ratios greater than 100 percent, and roll-in of prior vehicle's loan balance). Discuss with management the risks of any significant concentrations, such as a high percentage of sport-utility vehicles or a significant percentage of the portfolio maturing within a given time frame.

14. Determine whether the bank carries material volumes of lease-like loans[53] and incorporate this information into the leasing and residual risk[54] analysis.

15. If the bank is engaged in leasing and offers lease-to-loan or lease-to-lease products at the end of the lease term, evaluate the reasonableness of the underwriting criteria used. Be particularly sensitive to whether the activity allows for refinancing or renewing at amounts more than the value of the vehicle.

16. Review lease discounting (booking operations). Determine whether management has developed

[53] Lease-like loans have a put option that allows the customer to return the vehicle to the bank at maturity. Because of the put option, the bank is exposed to residual risk. Lease-like loans are most common in states where higher taxes are imposed on leased vehicles and in states with onerous liability statutes.

[54] Residual risk is the bank's exposure to the vehicle's fair value falling below management's residual value estimate.

- adequate processes for verifying key elements of the transaction (e.g., cap costs, residual values, and fees).
- MIS reports to track and evaluate the effectiveness of the discounting process.
- proper staffing levels in high-growth situations.

17. Assess the adequacy of the bank's policies, procedures, and practices with respect to lease residuals.

    - Determine whether lease residual values are established using guidebook values (e.g., ALG or *Kelley Blue Book*) or some other method and assess the reasonableness of the process and the values assigned.
    - Determine whether the bank enhances or adjusts guidebook values. If so, review the method and supporting documentation and assess the underlying rationale. Examples of enhancements include
      - adding dealer-installed optional equipment that is not consistent with guidebook add-ons.
      - using a value that exceeds the maximum recommended manufacturer's suggested retail price.
      - originating an odd-term lease, such as 39 months, but basing the residual value on a 36-month maturity.
      - allowing free or bonus mileage.
    - Review compliance with ASC 840 by determining whether
      - management reviews residual values at least annually.
      - management uses appropriate assumptions in its reviews.
      - any other than temporary impairment identified during the management reviews is expensed.
      - any write-downs are subsequently revised up.
    - Review any residual value insurance programs, including
      - management's process for selecting coverage.
      - type of insurance (e.g., catastrophic, full, full with deductible, and deductible), and any limitations or exclusions.
      - basis for determining premiums.
      - historical trends of insurance claims versus premiums paid by book of business.
      - basis for approving or denying insurance claims.
    - If time permits, test submitted claims that have been denied, partially paid, and paid in full.

18. Review the appropriateness of bank management procedures for determining whether a lease transaction should be accounted for as a direct finance lease or as an operating lease.

Collections

Conclusion: Based on the responses to procedures, the quality of risk management for the bank's collection activities is (strong, satisfactory, insufficient, or weak).

Objective: To evaluate the effectiveness of the collection function, including the collection strategies and programs employed, to better assess the quality of the portfolio and the quantity and direction of credit risk.

General

1. Assess the structure, management, and staffing of the collections department. If not previously performed,

    - review the department's organization chart and evaluate the quality and depth of the staff based on the size and complexity of the operation.
    - discuss with senior management staffing plans for each major collection activity (e.g., early stage, late stage, fraud, and agency management—both third-party collection and credit counseling agencies), including how plans fit with department and bank objectives (e.g., growth and credit performance projections).
    - review the experience levels of senior managers and supervisors.
    - through discussions with management, assess the adequacy of the bank's training program for collectors.
    - assess the appropriateness and administration of the bank's incentive pay program for collectors. Pay particular attention to possible negative ramifications of the plan, such as the potential to encourage protracted repayment plans, aggressive curing of accounts, or individual rather than team efforts. Determine whether the plan limits the total incentive pay a collector can receive.
    - determine whether the board or senior management reviewed and approved the incentive pay program before implementation.

2. Assess the adequacy of the bank's written collection policies and procedures. Determine whether they cover all significant collection activities and are consistent with OCC Bulletin 2000-20. Refer to the checklist in appendix C.

    - Verify that the bank's policies prohibit the rebooking of accounts that are charged off for anything other than bank error.
    - Determine whether the bank is considered a debt collector[55] as defined by the Fair Debt Collection Practices Act. If so, ensure appropriate review at the next compliance examination.
    - Determine whether the bank reviews if the borrower is a service member protected by the Servicemembers Civil Relief Act.
    - Determine whether management has implemented automated decisions (e.g., charge-off or extensions) that are consistent with the above policy guidelines.

3. Evaluate the adequacy of the bank's classification, nonaccrual, and charge-off practices and whether the practices comply with the bank's written policies and procedures. Specifically,

[55] Refer to 15 USC 1692a(6), "Definitions: Debt Collector."

- discuss practices with management and line personnel. Identify any inconsistencies with policies and procedures versus practices. Ensure that examiners assisting with the collection review and conducting testing are aware of these inconsistencies.
- identify where management has implemented automated processes versus manual processes to comply with policies. Review the system settings to verify that the parameters correspond to those described in the bank's policies and are consistent with OCC Bulletin 2000-20. If not, discuss the differences with management and request appropriate corrective action.
- request management's summary of classified installment loans. Determine whether the classification practices are consistent with OCC Bulletin 2000-20. Generally, all installment loans should be classified substandard at 90 days past due.
- request management's summary of nonaccrual installment loans. If the bank does not place installment loans on nonaccrual, determine whether the bank employs appropriate methods to ensure income is accurately measured (e.g., loss allowances for uncollectible fees and finance charges).
- determine how accounts scheduled for charge-off are loaded into a charge-off queue or other system for loss. Specifically, determine whether losses are automatically or manually processed, what circumstances, if any, will delay a charge-off, and when the bank recognizes losses (i.e., daily, weekly, or monthly).
- request a report detailing installment loan accounts more than 120 days past due that have not been charged off or, if secured, written down to the value of collateral, less cost to sell. Review the report with management and determine why those balances remain on the bank's books and whether there are system or policy issues that need to be corrected.

4. Evaluate the adequacy of the bank's policies and practices for payment posting and assessing late fees.

    - Review the payment posting procedures and practices and determine whether payments are promptly posted.
    - Determine the conditions under which late fees are imposed[56] and, if applicable, at what point the fees are suspended.
    - Determine the bank's policy for collecting late fees (e.g., as part of the next regularly scheduled payment) and how unpaid late fees are accounted for, tracked, and collected.
    - Determine whether the bank's process for evaluating the ramifications of changes in late fee policies, including dollar amounts and grace periods, is adequate before broad implementation.
    - Assess whether the available MIS reports provide the information necessary to evaluate the effect of late fees. Specifically, assess whether the information is sufficient to allow management to determine whether the fees have the desired effect

[56] Pyramiding late fees occur when a bank assesses a late fee when the only delinquency is attributable to the late fee assessed on an earlier installment and the payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period. OCC Bulletin 2014-42 states that, depending on the facts and circumstances, this practice may be found to be an unfair or deceptive act or practice in violation of section 5 of the Federal Trade Commission Act.

on performance (i.e., improve on-time payments), whether late fees result in negative amortization, and the extent to which late fees assessed are actually collected.
- Determine whether the bank has established adequate loss allowance for accrued but uncollectible interest and fees, including late fees, in either the ALLL or a separate reserve.

5. Assess the appropriateness of management's collection strategies.
   - Through discussions with management, determine how management develops collection strategies, who is responsible, and how the success of the strategies is measured.
   - Determine what triggers strategy changes and who has authority to direct revisions.
   - Establish whether the bank uses scoring or any other predictive techniques to assist in the collection of accounts. If so, determine
     - scores or techniques used, how they are used, and whether they are internally or externally developed.
     - when the scores or techniques were last validated, by whom, and the results of the validation.

6. If applicable, assess the adequacy of the bank's use of champion/challenger strategies.

   - Identify the person or group responsible for strategy development.
   - Determine whether the development process begins with a clear identification of strategy objectives and relies on reasonable assumptions and complete and accurate MIS.
   - Determine whether the bank's controls provide for proper testing (i.e., test size, time frame, and account population and characteristics) of challenger strategies before making decisions to expand challenger penetration or to replace the existing champion strategy.
   - Assess the monitoring process and determine whether the bank accumulates and analyzes appropriate data to measure strategy success.
   - Determine whether the bank maintains adequate documentation of the various strategies.

7. Determine whether the bank uses cure programs, such as extensions, deferrals, renewals, rewrites, or settlement or forgiveness programs. If so,

   - assess the adequacy of the policies and procedures used to administer the programs and consistency with OCC Bulletin 2000-20 regarding limits, analysis, documentation, amortization periods, and ALLL considerations.
   - review and evaluate any test and analysis summaries completed before the implementation of new cure programs.
   - determine whether the bank's programs appropriately address TDR and proper income recognition for restructured loans.
   - evaluate the MIS and reporting used to monitor and analyze the performance of each program. Compare performance with forecasts and bank objectives and tolerances. In

addition to reports listed in procedure 10, determine whether management generates and reviews reports detailing
  - volume (balance and unit) trends for cure program accounts, by product, program, vintage, and in total.
  - loss performance, by product, program, vintage, and in total.
  - performance of the accounts 30, 90, 180, 270, 360, etc., days after the cure.
  - performance of accounts cured more than once, broken down by the number of times cured and tracked over time.
  - policy exceptions and the performance of those exceptions.
- compare the performance of accounts in cure programs with the performance of those in the general installment population using performance measures in the above item.
- assess the current and potential impact of such programs on the bank's reported performance (asset quality) and profitability, including ALLL and capital implications.

(**Note:** If management accepts external debt management plans, such as CCC, management should be able to monitor the performance of accounts by individual credit counseling agency.)

8. Review the bank's "skip-tracing" practices and the procedures used to track delinquent customers and determine the practices and procedures' effectiveness.
   - Ascertain what portion of the portfolio lacks current or correct telephone numbers and mailing addresses.
   - Evaluate the adequacy of the bank's process for obtaining missing contact information.
   - Determine whether the bank has a process to exclude accounts without pertinent contact information from promotional initiatives and favorable account management treatment.
   - If applicable, determine whether the bank appropriately monitors outside agencies used to skip-trace accounts.
   - Determine whether skip accounts are flagged for accelerated charge-off if attempts to locate the borrower are unsuccessful.

9. Assess whether the bank's automated systems for collecting delinquent accounts are adequate and discuss these systems with management.

   - Determine which technologies and processes the bank uses to collect accounts (e.g., automated dialers, collection letters, statement messaging, and videos), how each is used, and the key reports generated to monitor performance. With respect to reports generated, determine whether they provide sufficient data to allow management to make appropriate decisions.
   - If auto-dialing is used, determine how the system routes "no contact" accounts or accounts that collectors remove from the dialer because of a promise to pay or a payment arrangement.
   - Determine whether the systems generate a sufficient audit trail.

- Determine whether managers, supervisors, and QC staff have the ability to listen to collector phone calls online.
- Evaluate the adequacy of the bank's contingency plans and determine whether the plans are tested regularly.

10. Assess the quality, accuracy, and completeness of MIS reports and other analyses used to manage the collections process. Specifically,

    - evaluate the quality of MIS collection reports regularly provided to executive management and determine whether the reports provide adequate information, including comparisons with collection objectives and tolerances, for timely decision making.
    - determine the appropriateness and accuracy of key collection reports. Review specifically
      - vintage and coincident delinquency and loss reports.
      - roll-rate reports and migration-to-loss reports.
      - cure program reports in total, by program, and by collector, including reports that track the volume (number and dollar) of accounts entering cure programs, accounts awaiting extension, and the actual performance of accounts in the various programs.
      - collector and strategy or special-handling queue reports.
      - productivity reports, including information such as call penetration, right-party contact, promises made and kept, dollars collected, and staffing summaries. (**Note:** If not removed, NSF checks can affect several of the metrics above. Management should have a method to identify, if not correct, the effects of NSF checks on the metrics.)
    - determine whether customer service or any department other than collections can initiate collection activities, such as cure programs. If so, determine whether appropriate monitoring MIS is in place to monitor volumes and credit performance of accounts in collection activities initiated outside collections.

11. Evaluate the adequacy of the bank's policies and procedures for repossession and the disposition of collateral.

    - Determine the point at which repossession processes are initiated.
    - Determine whether policies and procedures provide for timely disposition of collateral and maximize liquidation values.
    - Evaluate the adequacy of the bank's accounting for repossessed assets. Specifically, determine whether
      - repossessed assets are appropriately transferred from loans to repossessed assets at the lower of book or fair market value less cost to sell.
      - assets are routinely evaluated for impairment and whether impaired values are charged off at the end of each quarter, at a minimum.
      - management routinely reviews inventory aging reports and takes appropriate action on stale inventory (e.g., repossessed assets in the bank's possession longer than 90 days).

12. Determine what system(s) the bank uses to recover charged-off accounts and deficiency balances and whether the systems interface with the bank's collection management system(s). If not, determine how the recovery unit gathers and uses information about prior collection activities.

13. Determine whether the bank uses outside agencies (including attorneys and attorney networks) to collect delinquent accounts or recover losses. If so,
    - assess the bank's due diligence process for selecting vendors.
    - determine whether the bank's legal counsel and compliance officer have reviewed the contracts with and practices of third-party collectors.
    - evaluate any forward-flow contracts to collection agencies, including performance tolerances and termination requirements (important for remediation or severing the contract if poor performance is identified). (**Note:** Forward-flow contracts provide agencies a set number of accounts at a determined frequency and assist the bank in forecasting placements.)
    - determine the frequency and method of rotating accounts among collection and recovery agencies and in-house collections, i.e., distinctions between primary, secondary, and tertiary (including reasons supporting the method).
    - review productivity and cost reports for each vendor and discuss with management how the bank monitors the success of third-party collectors and places the workload accordingly.
    - evaluate the systems and controls used to supervise out-placed accounts, including active reconcilements of amounts collected and fees disbursed to each vendor.
    - review MIS used to monitor outside agencies' performance.
    - evaluate the adequacy and frequency of the bank's audits (on-site and off-site, if applicable) of third-party collectors.

    Note: Refer to the "Third-Party Management" section of this booklet's "Supplemental Examination Procedures" for additional guidance on reviewing third-party relationships.

14. Assess the bank's recovery performance using historical results and industry averages, by product, as guidelines.

    - Determine whether the bank periodically sells charged-off accounts. If so, determine the reasonableness of the bank's forecasts.
    - Determine whether there are systems in place to ensure the accuracy and completeness of file data on the sold accounts, including affidavits and other sworn documents.
    - Evaluate the bank's recoveries in light of prior period losses.
    - Evaluate the accuracy of the recovery figures. If the bank charges accrued but uncollected interest and fees against income rather than the ALLL, verify that recoveries are reported accordingly (i.e., include principal only).
    - Assess the costs associated with the dollars recovered and explore trends.

15. Assess the appropriateness of the bank's fraud policies and procedures.

- Review the bank's definition of fraud losses and determine whether it is reasonable and appropriately distinguishes fraud from credit losses.
- Determine consistency with the charge-off guidelines of OCC Bulletin 2000-20 (90 days from discovery).
- Confirm that fraud losses are recognized as operating expenses rather than charges to the ALLL.
- If the investigation negates the fraud allegation, verify that the bank returns accounts to the previous delinquency status and immediately reinstates collection efforts.

Note: When an account is reported as fraudulent, the reason should be given (either because account activity is alleged to be fraudulent, because it is confirmed to be fraudulent, or because the application is fraudulent). An account that has had an NSF check or that did not make the first payment should not automatically be identified as fraudulent.

16. Review the adequacy of MIS reports pertaining to fraud.

    - Determine whether the information is sufficient to monitor fraud and the effectiveness of fraud controls, including the appropriate filing of SARs.
    - Assess the levels and trends of fraud losses, by product, compared with industry averages and discuss any atypical findings with management. (**Note:** Fraud losses are often depicted as fraud losses divided by sales.)

17. Assess the adequacy of internal and external audit, QC, loan review, and risk management in the collections area, including scope, frequency, timing, report content, and independence.

    - Review relevant audit, QC, loan review, and risk management reports.
    - Determine the adequacy and timeliness of management's responses to the issues identified and any findings or issues requiring follow-up. Test corrective action, if warranted based on the significance of the issue or concerns about the adequacy of the response or action taken.

18. Conduct transaction testing to verify initial conclusions about the bank's collection programs and activities. In addition to determining adherence to approved policies and procedures, determine whether the programs and activities result in an enduring positive change in credit risk or provide temporary relief. Verify that MIS reports accurately capture the activities and the subsequent performance of the accounts (refer to appendix A, "Transaction Testing," for additional guidance).

    - Sample accounts that were at least 60 days delinquent in the month preceding the examination and are now current to determine whether the customer cured the delinquency or whether the account was cured artificially (e.g., by an extension). If the latter, determine whether the action was consistent with existing bank policy and whether it was consistent with OCC Bulletin 2000-20.

- Sample accounts from each of the primary collection areas (e.g., early stage, late stage, skip, and bankruptcy) to determine adherence to policy. The sample helps an examiner understand the collection process and strategies employed. (**Note:** This sample is often best completed or supplemented by sitting with collectors as they work accounts.)
- Sample loans from each of the following areas to assess compliance with bank policies and reasonableness of decisions: recent extensions, deferrals, renewals, modifications, and rewrites. Decisions should also be compared with the bank's normal underwriting guidelines with respect to LTV, amortization period, debt or repayment limitations, and pricing.
- Sample charged-off accounts and review all activities that occurred before charge-off to determine whether the bank employs practices that result in loss deferral.
- Sample identified fraud accounts, and review all activities to determine the appropriateness of practices, adherence to policy, and timeliness of charge-off practices.

19. Develop conclusions about the effectiveness of the collection function, including the collection strategies and programs employed, and the implications for the quality of the portfolio and the quantity and direction of credit risk.

Vehicle Loans and Leases

20. Assess repossession activity and performance, including the timeliness and appropriateness of repossession charge-offs and disposal, to determine whether management is aware of any third parties, including subcontractors, used during the process.

    - Assess the bank's method of valuing repossessed assets and determine whether repossessions are written down to fair value at the time of repossession or upon sale. If the latter, determine whether sales occur promptly and that the value of the asset is adequately adjusted in the interim for repossessions with protracted selling periods.
    - Evaluate how the bank disposes of repossessed assets. Focus on arrangements with local dealers, auction houses, and public or private sales, and how well management times the sales and balances inventory allocation with the various vendors.
    - Review repossession volumes and trends, including repossession rate (number of repossessions per 1,000 accounts), partial and full balance loss per repossession, and average time to disposal. For large automobile lenders, performance differences may be noted by geographic area, make, and model.

21. For leasing, review the accounts receivable aging for end-of-term fees, including excess mileage, wear and tear, and termination or disposition fees. Determine the level of the bank's success with collecting these fees and assess the need to write off uncollectible receivables if the fees are recognized on an accrual basis. Many lessors recognize fees on a cash basis.

22. Determine how management reviews vehicle residuals for other than temporary impairment, consistent with ASC 840. Verify that bank management expenses other than temporary residual impairment (writes the residual down to the anticipated residual value).

23. Review management's residual realization reports.[57] For those segments with consistent residual realization rates less than 100 percent, determine the effectiveness of bank management's procedures for recognizing other than temporary impairment of residuals. Direct bank management to recognize other than temporary residual impairment, if appropriate.

24. Determine whether the bank offers extensions to its lease customers. If so, determine how management quantifies, analyzes, and tracks other than temporary impairment for this segment of the portfolio. (**Note:** Extending the term of the lease through payment extensions creates additional risk of loss due to additional vehicle depreciation.)

25. Review the matured lease report and identify leases where the lessee has failed to return the vehicle. Review the adequacy of the bank's procedures for charging off these balances as uncollectible.

Off-Lease Vehicle Remarketing

26. Assess how well the bank manages and reports on leases that have run their full term.

    - Discuss with management the bank's vehicle remarketing methods (e.g., direct retail, auction, dealer consignment, and wholesalers).
    - Review and discuss scheduled runoff reports to identify concentrations (e.g., lease maturities, vehicle types, manufacturers, models, and geographic location).
    - Determine the appropriateness of staffing levels based on the marketing method and projected turn-in volume.
    - Review past and present turn-in volume and management's projections for next year.
    - Assess the effectiveness of strategies used before lease termination to minimize turn-ins (e.g., settlement offers and lease-to-loan or lease-to-lease products).
    - Determine whether the bank's systems can analyze the costs and benefits of moving vehicles to different geographic areas to maximize sales value.
    - Review bank management's procedures for charging off balances in excess of the net realizable value.

27. Review and assess the adequacy of management reports used to determine the effectiveness of the remarketing process. Reports should include

    - average loss or gain on remarketed vehicles in total and by vehicle segment.

[57] Residual realization reports detail profitability by items such as lease term, make, model, and model year. Residual realization equals the net cash received from the sale of the vehicle divided by the booked residual value and expressed as a percentage.

- average loss or gain on remarketed vehicles by original term.
- comparisons of amounts received at sale versus average guidebook value.
- return rates in total, by lease term, and by vehicle type, make, and model.
- off-lease inventory aging reports.
- sales reports for sold inventory.
- matured lease reports when the lessee has failed to return the vehicle.
- comparison of actual results and metrics with the bank's objectives and tolerances for remarketing.

Secured Loans Discharged in Chapter 7 Bankruptcy

Conclusion: Based on the responses to procedures, the quality of risk management for the bank's secured loans discharged in Chapter 7 bankruptcy collection activities is (strong, satisfactory, insufficient, or weak).

Objective: To determine the extent of secured loans discharged in Chapter 7 bankruptcy in installment lending activities and evaluate the effectiveness of management's oversight and risk management processes.

1. Obtain and review management reports discussing loans discharged through Chapter 7 bankruptcy. (**Note:** Since the debt was discharged in bankruptcy, the debtor has no personal obligation to pay the debt any longer—the debtor is likely paying the debt to retain the collateral.)

2. Determine whether the bank's repayment analysis documents the following three factors:

   - Existence of orderly repayment terms for structured collection of the debt without the existence of undue payment shock or the need to refinance the balloon amount.
   - History of payment performance that demonstrates the borrower's ongoing commitment to satisfying the debt before and through the bankruptcy proceeding.
   - Consideration of post-discharge capacity that indicates the borrower can make future required payments from recurring, verified income.

   Lack of consideration of these three factors could subject the bank to examiner criticism.

3. Determine whether post-discharge repayment capacity mirrors the bank's established ability to repay requirements (e.g., debt-to-income ratio or net disposable income) for new loans or sustainable loan modification programs. (**Note:** Banks may use income and debt information from bankruptcy proceedings if such information is available and deemed reliable.)

4. Determine whether the documentation would enable a third party (such as a person responsible for the control function within the bank, an examiner, or an auditor) to reasonably reconstruct the analysis and accept the conclusion after the fact. (**Note:** If the

factors clearly demonstrate that repayment in full is likely despite the bankruptcy discharge, the loan may remain on accrual status at the existing recorded balance.)

5. If objective evidence demonstrates that a portion of the loan is uncollectible, determine whether management has charged down the loan to the fair value of the collateral less cost to sell within 60 days of notification from the bankruptcy court as recommended in OCC Bulletin 2000-20. (**Note:** Typically the bank does not seek to collect payment on the discharged debt other than through repossession of the collateral.)

6. Determine whether management monitors exposures and considers bankruptcy loans separately for ALLL purposes. Generally, if a loan subsequently becomes 60 days past due, it is charged down to the fair value of the collateral less cost to sell.

7. Ascertain whether post-discharge payments received are applied to reduce the recorded investment until doubt no longer exists. When doubt exists as to the collectability of any remaining recorded investment (e.g., after any charge-off), loans should be maintained on nonaccrual status (**Note:** Once the remaining recorded investment is considered fully collectible, interest income may be recognized on a cash basis.)

8. Determine whether the collectability analysis requires judgment, including consideration of payment performance, lien position, collateral values, and other relevant factors. (**Note:** In general, nominal collateral coverage alone is not sufficient to satisfy collectability questions, especially when values or valuation methods may be unstable or uncertain.)

9. Determine whether any nonaccrual assets were restored to accrual status based on the assurance that none of the loan's principal and interest is due and unpaid. Further, determine whether the bank expects full repayment of the remaining pre-discharged contractual principal and interest (including any previously charged-off amounts). (**Note:** Depending on facts and circumstances, a bank may consider post-discharge payment performance as evidence of collectability if performance demonstrates both capacity and willingness to repay the full amounts due.)

10. A bank's analysis may be performed at a pool or individual loan level and should consider using the following three factors:

    - Monthly payments include principal and interest that fully amortize the remaining debt over the remaining term. Payment performance that consists of interest-only payments or terms that require balloon amounts raise questions about whether collection of loan principal is reasonably assured. For a loan that does not require full amortization, the bank may consider other factors, such as whether the borrower has consistently made payments above the minimum required to sufficiently amortize the balance over a reasonable period, thus demonstrating an ongoing ability to repay.
    - Sustained performance clearly demonstrates ongoing capacity and willingness to repay after the bankruptcy discharge. In accordance with call report instructions, timely post-discharge payments for a minimum of six months are necessary to

provide evidence of willingness and ability to pay the full amounts due. Longer periods may be appropriate depending on specific circumstances, such as when loan or pool characteristics indicate high re-default rates, when extended periods are necessary for borrowers to restore positive equity, or when economic conditions are unstable or deteriorating.

- Collateral levels support the likelihood that the bank will recover the full amount due even if payments cease. The discharge of the debtor's personal liability increases the importance of secondary sources of repayment, and substantial collateral deficiencies may make full collection (including charged-off amounts) uncertain and not reasonably assured.

ALLL

These supplemental examination procedures should be used when assessing the portion of the ALLL applicable to the bank's installment lending activity.

Conclusion: Based on the responses to procedures, the quantity of risks is (low, moderate, or high), and the quality of risk management for the ALLL of the bank's installment lending activities is (strong, satisfactory, insufficient, or weak).

Objective: To assess the adequacy of the bank's ALLL methodology for its installment lending activities.

1. Determine whether the amount of the ALLL is appropriate and whether the method of calculating the allowance is sound. Assess whether bank management routinely analyzes the portfolio to identify instances when the performance of a product or some other segment (e.g., workout programs) varies significantly from the performance of the portfolio overall and that such differences are adequately incorporated into the allowance analysis. Refer to the "Allowance for Loan and Lease Losses" booklet of the *Comptroller's Handbook* for information and specifically consider

   - whether estimates and assumptions are documented and supported in a manner consistent with OCC Bulletin 2006-47.
   - credit quality, including any changes to underwriting, account management, or collections that could affect future performance and credit losses.
   - historical credit performance and trends (e.g., delinquency roll-rates and flow-to-loss), overall, by product, and by vintage within products.
   - level, trends, and performance of subprime and other higher-risk populations.
   - level, trends, and performance of cure or workout programs, including re-agings, extensions, deferrals, renewals, modifications, and rewrites.
   - levels and trends of bankruptcies and the performance of accounts in bankruptcy that remain on the bank's books (including accounts that have been reaffirmed and those that have not).
   - charge-off practices and consistency with OCC Bulletin 2000-20.

- whether bank management provides for accrued interest and fees deemed uncollectible in the allowance or in a separate reserve.
- existence of concentrations.
- the effects of securitization activities, if applicable.
- economic conditions and trends.

Profitability

Conclusion: Based on the responses to procedures, the quantity of risk is (low, moderate, or high) and the quality of risk management is (strong, satisfactory, insufficient, or weak) for the profitability of the bank's installment lending activities.

Objective: To assess the quantity, quality, and sustainability of earnings from installment lending.

Note: For banks that securitize, examiners should also review income statements for managed assets.

1. Obtain and review copies of the income statement for the installment loan portfolio and for each significant product. Determine whether the reports are "fully loaded," i.e., that they include all pertinent income and expense items including overhead and funding costs.

2. Determine the installment loan portfolio's contribution to corporate earnings and its expected future contribution.

   - Review executive management monthly and/or quarterly performance and portfolio quality MIS reports.
   - Review historical trends, including changes in the product contributions.
   - Review financial projections and budget and plan variances.
   - Review significant income and expense components and measures. Items reviewed should include noninterest income (fees and other add-ons), marketing expense, charge-offs, net interest margin, and risk-adjusted yield.
   - Evaluate the methodologies, assumptions, and documentary support for the bank's planning and forecasting processes. Determine whether material changes are expected in any of the key income and expense components and measures.
   - Determine management's return on assets, return on managed assets, and return on equity hurdles and the actual returns as of the examination date. (**Note:** Asset-based measures are typically more meaningful for comparison because banks allocate capital differently.)

3. Verify that the bank appropriately recognizes uncollectible accrued interest and fees through the ALLL, a separate interest and fee reserve, or cash income recognition.

4. To assess sustainability, review the bank's stress test and discuss with management potential earnings volatility through an economic cycle. If the bank does not perform

stress testing, discuss whether and how management prices loans to withstand economic downturns.

5. Determine whether the bank's cost accounting system is capable of generating profit data by product, segment (including grade), channel, and account.

6. Assess the profitability of each installment loan product.
   - For each product, review profitability by credit score band, credit grade, sub-portfolio, segment (e.g., LTV differences), and vintage, as appropriate.
   - Compare actual results with projections and discuss variances with management.

7. Evaluate profitability by channel.

   - Through discussions with the examiner responsible for third-party management, determine profitability generated through the various channels (e.g., dealers, brokers, and third-party originators).
   - Compare the profitability of the loans generated by the various channels.

8. Determine the adequacy of the pricing method.

   - Review the pricing strategy, pricing method, and pricing model, if applicable.
   - Review the major assumptions used in the pricing method and assess reasonableness. Be alert to differences in assumptions by product and channel.
   - Determine whether pricing is driven by risk, capital, or some other allocation method or hurdle, and how much, if any, it is driven by the competition.
   - Determine whether the pricing method incorporates a realistic break-even analysis and whether the analysis reflects the true costs of premature reductions (prepayment).
   - Review the pricing matrix, by product.

9. Assess the adequacy of planning, reporting, and analysis with respect to prepayment. Specifically, determine whether management identifies the volume and trends of accounts with high interest rates relative to market or low introductory rates to determine exposure and impact on earnings.

10. Develop conclusions about the quantity, quality, and sustainability of earnings from installment lending.

Third-Party Management

Conclusion: Based on the responses to procedures, the quantity of risk is (low, moderate, or high) and the quality of risk management (strong, satisfactory, insufficient, or weak) for the bank's third-party management activities.

Objective: To determine the extent of third-party involvement in retail lending activities and evaluate the effectiveness of management's third-party oversight and risk management processes.

Note: These procedures apply to any arrangements with third parties to provide installment lending-related services to customers on the bank's behalf. Banks may fully outsource loan originations (using brokers, dealers, or telemarketers, for example), collection activities (using collection agencies or attorneys), or the offering of products (debit and credit cards, for example) in the bank's name.
The terms "third party," "third-party vendors," and "vendors" are used interchangeably throughout the following procedures. "Third-party management" is the term used to describe the bank's process for overseeing these parties. Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk management Guidance," and OCC Bulletin 2002-16, "Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance," for additional information.

1. Determine the adequacy of the bank's third-party vendor management program.

    - Assess the adequacy of the third-party management policy and determine whether analysis, documentation, and reporting requirements are clearly addressed.
    - Determine whether management has designated an individual to be responsible for the program and has delegated to that individual the authority necessary for the program's effective administration.
    - Review the bank's process for maintaining a complete list of third-party vendors used in installment lending.
    - Review the bank's criteria for designating "significant" vendors according to the dollar amount of the contract, the importance of the service provided, and the potential risk involved in the activity.
      (**Note:** Although the third-party management program should address all vendor relationships, the program should have a more rigorous process to manage those third parties deemed significant.)
    - Review the bank's due diligence process and determine whether the process
      - provides for comprehensive, well-documented reviews by qualified staff.
      - identifies potential conflicts of interest with bank directors, officers, staff, and their related interests.
      - addresses consistency with safety and soundness supervisory guidance and compliance with all applicable laws and regulations, including those prohibiting lending discrimination and unfair or deceptive acts or practices.

2. Identify vendors that provide significant services on the bank's behalf, particularly those that provide loan origination, servicing, or complete products. Determine the bank's relationship manager for each of those vendors.

3. Verify that bank management's expertise in the outsourced activities is sufficient to accurately identify and manage the risks involved.

4. Determine whether management has adequate controls, including policies and procedures and monitoring controls, to avoid becoming involved with a third party engaged in discriminatory, unfair, deceptive, abusive, or predatory lending practices. Policies and procedures should address loans involving features or actions that have been associated with discriminatory, unfair, deceptive, abusive, or predatory lending practices, including

   - lending predominantly on the liquidation value of collateral rather than the borrower's ability to service the debt.
   - refinancing loans frequently.
   - requiring single-premium life insurance or similar products.
   - using negative amortization.
   - requiring balloon payments in short-term transactions.
   - charging prepayment penalties in the later years of a loan.
   - charging excessive financing points, fees, or penalties.
   - increasing interest rate upon default.
   - inserting mandatory arbitration clauses.
   - making high-cost loans, particularly to borrowers who would qualify for a prime loan.

   If weaknesses or concerns are found, consult the bank's EIC or compliance examiner.

   Note: For additional information, refer to the "Fair Lending" and "Truth in Lending Act" booklets of the *Comptroller's Handbook* and to OCC Advisory Letters 2002-3, 2003-2, and 2003-3.

5. Assess the adequacy of contract management, focusing on the process for ensuring that clauses necessary to effectively manage the vendor are included.

   - Determine whether there is a current contract on file for all third-party vendors and that the bank monitors key dates (e.g., maturity, renewal, and adjustment periods).
   - Review a sample of contracts with significant vendors to determine whether the contracts satisfactorily address
     - scope of the arrangement, including the frequency, content, and format of services provided by each party.
     - outsourcing notifications or approvals required, if the vendor proposes to subcontract a service to another party.
     - all costs and compensation, including incentives.
     - performance standards, including when and if standards can be adjusted, and the consequences of failing to meet those standards.
     - reporting and MIS requirements.
     - data ownership and access.
     - appropriate privacy and confidentiality restrictions.
     - requirements for compliance with all applicable laws and regulations, including consistency with safety and soundness supervisory guidance as well as laws and regulations prohibiting lending discrimination and unfair or deceptive practices.

  - if brokers and dealers are used in the loan origination process, requirements that the brokers and dealers make best efforts to ensure that the loans offered to borrowers are consistent with their needs, objectives, and financial situation.
  - mandatory third-party control functions, such as QC and audit, including requirements for submitting audit results to the bank.
  - expectations and responsibilities for business resumption and contingency plans.
  - responsibility for consumer complaint resolution and associated reporting to the bank.
  - third-party financial statement submission requirements.
  - appropriate dispute resolution, liability, recourse, penalty, indemnification, and termination clauses.
  - authority for the bank to perform on-site third-party reviews or to terminate contract due to noncompliance. (**Note:** Third-party performance of services is also subject to OCC examination oversight if warranted.)
- Determine whether the bank's monitoring of third parties' adherence to their contracts (especially to financial terms and performance standards) is adequate in frequency and scope.
- Determine whether issues identified through the monitoring process are appropriately resolved in a timely manner.

6. Assess the adequacy of the monitoring process for significant third parties.

   - Using the sample of significant third parties reviewed in the preceding procedure 5, confirm that the bank's oversight incorporates,
     - reports evidencing the third parties' performance relative to service level agreements and other contract provisions.
     - customer complaints and resolutions for the services and products outsourced.
     - third-party financial statements and audit reports.
     - compliance with applicable laws and regulations.
   - Evaluate whether the process results in an accurate determination of whether contractual terms and conditions are being met and whether any revisions to service-level agreements or other terms are needed.
   - Verify whether management documents and follows up on performance, operational, or compliance problems and whether the documentation and follow-ups are timely and effective.
   - Determine whether the relationship manager or other bank staff periodically meets with its vendors to discuss performance and operational issues.
   - Determine whether third-party management administers call monitoring, mystery shopper, customer call back, or customer satisfaction programs, if appropriate.
   - Assess the adequacy of the bank's process for determining when on-site reviews are warranted, the scope of those reviews, and reporting of results.
   - Determine whether management evaluates the third party's ongoing ability to perform the contracted functions in a satisfactory manner based on performance and financial condition.

7. For brokers, dealers, and other third-party loan originators,

- assess the adequacy of the process used to qualify third-party loan originators.
- assess the adequacy of the reports and tracking mechanisms to monitor performance (e.g., volume of applications submitted, approved, and booked; quality; exceptions; and loan performance) and relationship profitability, including performance and profitability compared with projections.
- assess the adequacy of the process used to monitor compliance with the bank's lending policies.
- verify that management maintains a watch list for problematic originators and that actions taken (including termination of the relationship, if warranted) are appropriate and timely.

8. Assess the adequacy of the content, accuracy, and distribution of third-party management program reports.

9. Determine whether the bank has any loans to the third party and whether conflicts of interest exist.

10. Determine whether any insiders have relationships with the third parties the bank uses and whether potential conflicts of interest exist (e.g., insider has ownership interests, officer or board positions, or loans to the third party).

11. Determine whether the bank is involved in any significant third-party relationships where deficiencies in management expertise or controls result in the failure to adequately identify and manage the associated risk. If so, consult the EIC and the supervisory office and determine whether it is appropriate to require that the activity be suspended pending satisfactory corrective action.

12. Develop conclusions about the extent of third-party involvement in retail lending activities and the effectiveness of management's third-party oversight and risk management processes. Clearly document all findings.

Asset Securitization

Conclusion: Based on the responses to procedures, the quantity of risk is (low, moderate, or high) and the quality of risk management is (strong, satisfactory, insufficient, or weak) for the bank's installment loan securitization activities.

Objective: To determine the amount of asset securitization in installment lending activities and the quantity of risk and quality of risk management.

1. Determine the quantity of risk and the quality of risk management by assessing whether the bank is properly identifying, measuring, monitoring, and controlling the risks associated with its securitization activities.

2. Determine whether the bank's strategic or business plan for asset securitization adequately addresses resource needs, capital requirements, and profitability objectives.

3. Determine whether asset securitization policies, practices, procedures, objectives, internal controls, and audit functions are adequate.

4. Determine that securitization activities are properly managed within the context of the bank's overall risk management processes.

5. Determine the quality of operations and the adequacy of MIS.

6. Determine compliance with applicable laws, rulings, regulations, and accounting practices.
7. Determine the level of risk exposure presented by asset securitization activities and evaluate that exposure's impact on the overall financial condition of the bank, including the impact on capital requirements and financial performance.

8. Based on results from the previous steps and discussions with the bank EIC and other appropriate supervisors, initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient, or when violations of law, rulings, or regulations have been noted.

Stress Testing

Conclusion: Based on the responses to procedures, the quantity of risk is (low, moderate, or high) and the quality of risk management is (strong, satisfactory, insufficient, or weak) for the bank's installment lending stress testing activities.

Objective: To determine the effectiveness of the banks stress testing framework for installment lending activities.

1. Determine if the bank uses stress testing to assess its installment lending activities.

2. Determine if the bank policies articulate consistent and sufficiently rigorous stress testing practices.

3. Determine if stress testing roles and responsibilities include controls over external resources used for any part of stress testing (such as vendors and data providers).

4. Determine if the frequency and priority of stress testing is reasonable.

5. Determine who uses stress test results and that results outline instances in which remedial actions are taken.

6. Determine if the banks stress testing practices are reviewed and updated as necessary to ensure the practices remain appropriate and keep up to date with changes in market conditions, products and strategies, exposures and activities, the banks established risk appetite, and industry stress testing practices.

Debt Suspension and Cancellation

Conclusion: Based on the responses to procedures, the quantity of risk is (low, moderate, or high) and the quality of risk management is (strong, satisfactory, insufficient, or weak) for the bank's installment lending debt suspension and cancellation activities.

Objective: To assess any debt suspension and cancellation programs and determine the implications for income, credit quality, program performance, and level of compliance. While FSAs are not subject to 12 CFR 37, both national bank and FSA management should develop and implement appropriate risk management processes for oversight of these products.

Note: These procedures should be completed if debt suspension and cancellation products have significantly penetrated the loan portfolio or shown substantial growth or plans for growth. The term "debt waiver" is used throughout the procedures below to describe these programs, regardless of whether a principal reduction is involved.

1. Determine whether the bank offers any type of debt suspension and cancellation products. If so, determine which installment loan products are eligible for debt waiver programs (e.g., automobile).

2. Determine program features and assess the adequacy of those features and whether they are accurately described in marketing and in the disclosures of terms and conditions provided to bank customers.

3. Determine whether marketing and promotional materials and disclosures comply with 12 CFR 37.6(e) and contain the necessary disclosures as applicable.

4. Assess the adequacy of the policies, procedures, and practices for each debt waiver product or program. Test adherence to bank policy by reviewing a sample of at least 30 approved and 30 denied claims.

5. Assess compliance with 12 CFR 37. Confirm that the national bank

   - does not extend credit or alter the terms or conditions of credit conditioned on the customer entering into a DCC or DSA (12 CFR 37.3(a)).
   - does not engage in any practice or use any advertisement that could mislead or otherwise cause a reasonable person to reach an erroneous belief with respect to information that must be disclosed (12 CFR 37.3(b)).
   - does not offer DCCs or DSAs that give the bank the right to unilaterally modify the contract or agreement unless the modification is favorable to the consumer without additional charge or the customer is notified of the proposed change and given a reasonable opportunity to cancel the contract without penalty before the change becomes effective (12 CFR 37.3(c)(1)).

- does not offer DCCs or DSAs that require a lump-sum single payment for the contract or agreement payable at the outset of the contract when the debt subject to the contract is a residential mortgage loan (12 CFR 37.3(c)(2)).
- does not provide customers a no-refund DCC or DSA unless also offering a comparable product that provides for a refund of any unearned fees paid for the contract if the contract is terminated (12 CFR 37.4(a)).
- obtains a customer's written acknowledgement to purchase a contract and written acknowledgement that the customer received the long-form disclosures (12 CFR 37.7(a)).
- if it sells a contract over the telephone,
  - maintains sufficient documentation to show that the customer received the short-form disclosures and affirmatively elected to purchase a contract or agreement (12 CFR 37.7(b)(1)).
  - mails the affirmative written election and written acknowledgement together with the long-form disclosures to the customer within three business days after the telephone solicitation and maintains sufficient documentation to show it made reasonable efforts to obtain the documents from the customer (12 CFR 37.7(b)(2)). (**Note:** If the product only becomes effective when there is a return of the election, then does the bank ensure that the borrower is not billed for the product?)
  - permits the customer to cancel the purchase of the contract or agreement without penalty within 30 days after the bank has mailed the long-form disclosures to the customer (12 CFR 37.7(b)(3)).
- if a contact is solicited through written materials and the bank only provides the short-form disclosures,
  - mails the acknowledgement of receipt of disclosures, together with the long-form disclosures, to the customer within three business days, beginning on the first business day after the customer contacts the bank or otherwise responds to the solicitation (12 CFR 37.7(c)).
  - receives the customer's written acknowledgment of receipt of disclosures, unless the bank
    - maintains sufficient documentation to show that it provided the acknowledgement of receipt of disclosures to the customer (12 CFR 37.7(c)(1)).
    - maintains sufficient documentation to show it made reasonable efforts to obtain from the customer a written acknowledgement of receipt of the long-form disclosures (12 CFR 37.7(c)(2)). (**Note:** If the product only becomes effective when there is a return of the election, then does the bank ensure that the borrower is not billed for the product?)
    - permits the customer to cancel the purchase of the contract or agreement without penalty within 30 days after the bank has mailed the long-form disclosures to the customer (12 CFR 37.7(c)(3)).

6. Select a sample of terminated DCCs and DSAs to determine that the bank (12 CFR 37.4))

- refunded to the customer any unearned fees paid, unless the contract provides otherwise (12 CFR 37.4(a)).
- calculates the amount of refund using a method at least as favorable to the customer as the actuarial method (12 CFR 37.4(b)).

7. Through discussions with lending officers and a review of the bank's training program, determine whether personnel provide and are trained to provide

   - short-form disclosures orally at the time the bank first solicits the purchase of a contract (12 CFR 37.6(c)(1)).
   - long-form disclosures in writing before the customer completes the purchase of the contract (12 CFR 37.6(c)(2)).
   - long-form disclosure in writing to the customer if the initial solicitation is in person (12 CFR 37.6(c)(2)).
   - short-form disclosures orally to the customer and mail long-form disclosures, and a copy of the contract, if appropriate, to the customer within three business days, beginning the first business day after a telephone solicitation (12 CFR 37.6(c)(3)).
   - long-form disclosures that are mailed to the customer within three business days, beginning on the first business day after a customer responds to a mail insert or "take one" application (12 CFR 37.6(c)(4)).
   - disclosures, if provided through electronic media, that are consistent with the Electronic Signatures in Global and National Commerce Act (15 USC 7001 et seq.) requirements (12 CFR 37.6(c)(5)).

8. Determine whether the national bank complies with the disclosure requirements of 12 CFR 37, "Debt Cancellation Contracts and Debt Suspension Agreements," by completing appendix E, "Debt Suspension and Debt Cancellation Product Information Worksheet."

9. Assess the quality of the MIS used to monitor and administer debt waiver programs. The bank's monthly debt waiver program reports should be sufficient to accurately determine

   - enrollment volume and trends, including
     - number and account balances of accounts enrolled in the program.
     - cancellation rate, segmented by customer versus bank closure (early cancellation rates can be an indication that customers are being "slammed" by unscrupulous telemarketers).
   - application and activation volume and trends, including
     - average claim processing time, by type.
     - benefit application, approval, denial, and fallout[58] rates. Denial rates can be used as an indication of potentially unfair and deceptive practices.
     - number and account balances of accounts in benefit status.

[58] Fallout refers to failure to satisfactorily complete the debt waiver claim. Examiners should be alert to UDAP when bank/vendor makes it too difficult to prove a case that applicant just gives up.

  - average duration of benefit period by type and aging of active benefits (time to benefit exhaustion).
  - delinquency status of accounts in active benefit status, by type.
  - performance of accounts after benefit denial, fallout, and benefit exhaustion.
- profitability, including
  - fee income generated.
  - average annual percentage rate of enrolled and activated accounts.
  - costs of active benefits, including retroactive adjustments, by type.

Note: If the bank securitizes, the above information should be broken down by receivable ownership (bank, trust, trust series, etc.) and aggregated for the managed portfolio overall. It should be used to evaluate program performance (current and trends, operational issues, etc.) and pricing, to establish adequate debt waiver interest and fee reserves, to set the amount of a trust's remittance (if any), and to analyze the ALLL.

10. Evaluate the quality and frequency of the debt waiver analyses performed.

- Determine whether management analyzes the performance of accounts. Confirm that the analysis includes the performance of accounts, by type of benefit claimed (e.g., unemployment, medical), for accounts
  - denied claims (examiners may want to listen to call recordings to identify concerns with a telemarketer and/or customer service representative discouraging a customer from making a formal complaint to avoid a "denial" by the firm).
  - failing to complete claims after notifying the bank.
  - after benefit expiration.
- Determine whether the accounts in the previous item perform differently than the rest of the respective portfolio. If so, determine whether the performance difference is appropriately incorporated into the ALLL analysis.
- Confirm the bank's analysis by reviewing a sample of accounts that came off benefits six months ago. Determine the current payment status of those accounts.

11. Determine whether the bank administers debt waiver programs in-house or whether they are outsourced to an affiliate or third party. If they are outsourced, review the governing contract, costs, and the controls to monitor performance.

12. Evaluate the accounting and profitability of the program.

- Determine the bank's accounting for debt waiver income and expenses.
- Determine whether the bank maintains an adequate reserve for claims benefits, if applicable.
- Assess the significance of debt waiver income to the bank's total income and evaluate income sustainability in view of program volume, claims experience, and cancellation rates, at a minimum.
- If the program is offered for accounts that are securitized, determine the bank's responsibility for income sharing and claims payments and review the supporting accounting entries. Confirm that trust reimbursements are accurate and timely.

13. Complete appendix E, "Debt Suspension and Debt Cancellation Product Information Worksheet," and retain a copy in the examination work papers.

14. Develop conclusions with respect to the bank's debt suspension and cancellation programs, including management and administration, and the implications for income as well as credit quality, program performance, and level of compliance.

Control Functions

Conclusion: Based on the responses to procedures, the quantity of risk is (low, moderate, or high), and the quality of control functions is (strong, satisfactory, insufficient, or weak) for the bank's risk management and control activities.

Objective: To evaluate the adequacy of the bank's processes for identifying, measuring, monitoring, and controlling risk by reviewing the effectiveness of risk management and other control functions.

Note: If the bank uses affiliates or third-party vendors for loan acquisition, servicing, control, or other key functions, refer to the "Third-Party Management" section of the "Supplemental Examination Procedures."

1. Assess the structure,[59] management, and staffing of each of the control functions, including risk management, loan review, internal and external audit, QC, and compliance review.

   Note: Although consumer compliance examiners generally assess the quality of the compliance review function, safety and soundness examiners should understand compliance-related roles, responsibilities, and coverage, as well as how compliance controls fit into the overall control plan.

2. Determine the roles, responsibilities, and reporting lines of the various control functions through discussions with senior management.

   - Review the organization chart for each function and evaluate the quality and depth of staff (including number of positions) based on the assigned role and the size and complexity of the operation. Specifically,
     - review the experience levels of senior managers and staff.
     - determine whether employees are capable of evaluating the line of business activities.
     - review management and staff turnover levels.
   - Discuss the structure and staffing plans, including known or anticipated gaps or vacancies, with senior management.

[59] Depending on the bank, risk management process may be managed from different areas in the bank (i.e., some from the line of business and others from the corporate offices).

- Review compensation plans to determine whether performance measurements are appropriately targeted to risk identification and control objectives.
- Determine whether organizational reporting lines create the necessary level of independence.

Note: If the management and staff of a control function lack the knowledge or capability to adequately review all or parts of installment lending activities, management may need to consult or hire appropriate outside expertise.

3. Discuss with senior managers how they ensure that significant risks are appropriately monitored by at least one control function and how they assess the effectiveness of each function.

4. Determine whether the risk management process appropriately monitors, analyzes, and controls the bank's credit risk.

   - Determine risk management's recurring responsibilities and major projects, including the status of the projects, and assess the adequacy of those activities in light of the bank's credit risk profile, the products offered, and the complexity of the operation.
   - Determine whether credit risk decisions involve all key functional areas, including risk management, marketing, finance, operations, compliance, legal, and IT, either formally or informally.
   - Determine whether risk management is involved in tactical credit decisions, such as credit program approvals, program renewals, new products, marketing campaigns, and annual financial planning.
   - Obtain descriptions of key management reports to determine the types and purposes of reports produced, report distribution, and frequency of preparation.
   - Obtain a sample of recent ad hoc or special studies or board reports produced by risk management to determine the types of analyses performed, the reasonableness of the scopes and methodologies used, and the accuracy of the conclusions drawn, including the adequacy of the support provided.
   - Determine what technologies and risk tools are deployed and risk management's role in the management of those tools, including data warehouse, portfolio management software, credit scoring and adaptive control systems, and risk models.
   - Determine whether market, competitive, legislative, and other external factors are considered in the risk management processes.

5. Determine whether management considers consumer complaints and complaint resolution in the risk management processes. Obtain copies of complaints reported to the OCC's Customer Assistance Group and the bank's consumer complaint logs. Evaluate the information for significant issues and trends.

   Note: Complaints serve as valuable early warning indicators for compliance, credit, and operational issues, including discriminatory, unfair, deceptive, abusive, or predatory practices.

6. Determine whether changes to practices and products, including new products and practices, are fully tested, analyzed, and supported before broad implementation (including compliance components). (**Note:** Refer to the "Underwriting, Credit Scoring/Modeling, and Marketing of Products" section of the "Supplemental Examination Procedures" for testing guidelines.)
7. Test the effectiveness of the bank's risk management processes for existing and new products, marketing and collection initiatives, and changes to risk appetite (e.g., initiating or changing credit criteria or adopting new scoring systems or technologies). Select at least one significant new product, account management practice (e.g., line increase, pricing, or payment holiday), or collections initiative (e.g., workout program or rewrite) and track it through all facets of the management process.

    - **Planning:** If tracking a new loan product, for example, determine how the bank developed new underwriting standards (i.e., how did it analyze the applicability of the underwriting criteria and marketing strategies then in use and what was the basis of any projections) and how it derived new criteria or strategies (i.e., what were the key drivers for credit or revenue).
    - **Execution:** Evaluate the adequacy of the process employed to determine whether new criteria and changes were implemented as intended. (**Note:** This component is generally performed by some combination of IT staff, product management, QC, audit, and loan operations.)
    - **Measurement:** Determine how adherence to standards is measured and how management measures affect the use of back-end monitoring and analysis. Determine the key measurements management uses to analyze the effectiveness of its decisions (e.g., responder analyses, first or early payment default, vintage reporting for delinquencies and losses, activation or booking, utilization, risk-adjusted margin, or profit and loss), and the adequacy of back-testing analyses (comparison to targets or identification and analysis of anomalies).
    - **Adjustment:** Determine how feedback results (lessons learned and opportunities identified) are incorporated into the process as course corrections or adjustments. Assess the process for making adjustments as problems or unexpected performance results are identified and whether the process is both timely and appropriate.

8. Determine whether the bank has the data warehousing capabilities (i.e., the capacity to store and retrieve pertinent data) to support necessary monitoring, analytical, and forecasting activities.

9. Evaluate executive management's monthly and quarterly report packages. Specifically,

    - determine whether the reports accurately and completely describe the state of the bank's installment lending.
    - evaluate whether reports adequately measure credit risk (e.g., score distributions and vintage reports), identify trends, describe significant variances, and present issues. (**Note:** Reports should allow management to assess whether installment lending activities remain consistent with strategic objectives and within established risk, return, and credit performance tolerances.)

- determine whether reports clearly show analysis of performance results and trends rather than merely depict data.

10. Obtain feedback from other examiners assigned to the retail credit examination regarding the adequacy of reports available.

Loan Review

11. Assess the adequacy of the loan review process for installment lending. Determine whether

    - loan review's scope includes providing a risk assessment of the quality of risk management and quantity of risk for installment lending in aggregate and by products within the portfolio.
    - scope includes appropriate testing for adherence to key credit policies and procedures.
    - scope includes appropriate reviews to assess compliance with applicable laws and regulations and consistency with guidance, including assessing whether any lending practices are discriminatory, unfair, deceptive, abusive, or predatory.
    - scope includes a review of the accuracy and adequacy of MIS reporting.
    - frequency of reviews is acceptable based on the significance of the risks involved.
    - staffing levels and experience are commensurate with the complexity and risk in the retail lending area.
    - loan review is independent from the production process.
    - loan review possesses sufficient authority and influence to correct deficiencies and curb dangerous practices.

12. Review recent loan review reports for installment lending. Determine whether

    - reports are issued in a timely manner following completion of the on-site work.
    - reports provide meaningful conclusions and accurately identify concerns.
    - significant issues require management's written response.
    - management initiates timely and appropriate corrective action.
    - issues identified and the status of corrective actions are tracked and reported to senior management.

    Note: Weaknesses identified by examiners but not by loan review may be evidence of deficiencies in loan review processes or staffing.

Quality Control

13. Assess the adequacy of the QC process for installment lending. Determine whether

    - the process assesses ongoing compliance with key credit and operational policies and procedures and with applicable laws and regulations for all primary areas, including
      - loan origination.

  - account management programs.
  - fraud.
  - customer service.
  - collections.

  (**Note:** QC processes should be established for all direct lending activities and any third-party loan servicing and origination arrangements.)

- QC tests the integrity and accuracy of MIS data for primary areas listed in the first bulleted item in step 13.
- frequency of reviews is properly geared to the significance of the risk.
- testing and sample sizes are appropriate.
- The QC function possesses sufficient authority and influence to correct deficiencies and curb dangerous practices.

14. Review a sample of QC testing worksheets and periodic summary reports (e.g., monthly summaries of testing conclusions). Determine whether

    - reporting process allows for timely feedback to management.
    - worksheets and summary reports accurately identify concerns.
    - significant issues require management's written response.
    - management initiates timely and appropriate corrective action.
    - issues identified and the status of corrective actions are tracked and reported to senior management.

    Note: Weaknesses identified by examiners but not identified by the QC function may be evidence of deficiencies in QC processes or staffing.

15. If the QC function is not independent from the loan production process, determine whether internal audit or loan review tests QC so that management can rely on the findings of the QC function.

16. If reviews and testing by the QC area exclude significant risk areas, communicate findings to the EIC to determine whether it is appropriate to complete transactional testing in areas not covered by QC.

Audit

17. Assess the adequacy of internal audit for installment lending. Determine whether

    - the scope includes appropriate testing for adherence to key credit and operational policies and procedures.
    - the frequency of reviews is properly geared to the significance of the risks.
    - internal audit is independent.

- internal audit possesses sufficient authority and influence to correct deficiencies or curb dangerous practices.

Note: Refer to the "Internal and External Audits" booklet of the *Comptroller's Handbook* for additional information.

18. Review recent internal audit reports for installment lending. Determine whether
    - reports are issued in a timely manner following completion of the on-site work.
    - reports accurately identify concerns.
    - significant issues require management's written response.
    - management initiates timely and appropriate corrective action.
    - issues identified and the status of corrective actions are tracked and reported to senior management.

    Note: Weaknesses identified by examiners but not identified by internal audit may be evidence of deficiencies in internal audit processes or staffing.

Compliance

Note: These compliance examination procedures include a safety and soundness focus. Refer to the *Consumer Compliance* series of booklets of the *Comptroller's Handbook* for further discussion and examination procedures related to consumer retail credit products.

Program Availability and Eligibility Standards

19. Review and assess the adequacy of the bank's policies, procedures, and practices for establishing program availability and eligibility standards. Specifically,

    - determine whether eligibility standards within the retail credit policies are approved by the bank's board of directors at inception and included in annual policy reviews thereafter.
    - evaluate the bank's minutes from the board meeting regarding program availability and eligibility standards, review the approval, and determine whether the policies and procedures exhibits are attached to the minutes.

20. Determine whether bank management has established policies and procedures that set forth the availability and eligibility criteria that a consumer must meet to obtain a retail credit product.

    - Review established policies and procedures to determine whether eligibility criteria are set forth.

21. Determine whether the bank gathers sufficient information to determine whether the consumer meets the bank's eligibility standards (e.g., relationship history, deposit history, and incidence of default or bankruptcy) before approving the consumer for a retail credit product.

- Identify a sample of loans for each product, using appropriate sampling methodology, and evaluate whether the bank's eligibility standards were considered, adhered to, and documented.

22. Determine whether the bank's policies and procedures clearly identify each available retail credit product.

    - Review the bank's marketing materials to evaluate whether all available retail credit products are adequately described. Obtain a list of all available products and compare to the bank's policies and procedures.
    - Features to evaluate include whether the bank clearly identifies product features and the credit criteria the consumer must meet to be approved for the loan.

Financial Capacity

Notes: For retail credit, specific underwriting criteria vary based on the level of risk the bank is willing to accept. The criteria are designed to measure an individual's financial capacity, in terms of disposable income or assets available for orderly debt repayment, and willingness to repay, which is typically evaluated with heavy reliance on past performance on financial obligations.

Sources of information used to assess an individual's creditworthiness vary—by bank and sometimes by product. Some banks rely solely on information the customer provides on a loan application, and some rely solely on credit bureau information. Most banks prefer a combination of both, relying on bureau data to gauge credit experience and performance and on the application to gather information not available on a bureau report, such as income, housing (own or rent), and time on the job. Banks may also use credit scores, which project the probability of future payment performance based on past experience.

23. Determine whether underwriting policies for a retail credit product were approved by the board at inception and included in annual policy reviews thereafter.

    - Evaluate whether the bank's minutes from board meetings specifically approve the credit underwriting policies for the consumer credit product(s).
    - Determine whether the credit underwriting policies are included in annual policy reviews submitted to the board as part of the annual approval process.

24. An assessment of the customer's financial capacity should be a part of the underwriting process for all retail credit. Review and evaluate the bank's policies and procedures for determining an applicant's creditworthiness and ability to repay the loan according to its terms.

- Determine whether the minimum underwriting criteria include guidelines for credit quality, generally including debt-to-income ratios, minimum credit scores (when used), maximum loan duration, and pricing.[60]
- Determine whether current income or assets are evaluated to determine financial capacity.

25. Evaluate whether the bank's credit underwriting policies and practices for a retail credit product are commensurate with the specific risks associated with the type of loan and the terms and conditions under which the loan will be made. Underwriting policies and practices among banks vary but should be appropriate based on the type of credit product.

    - Evaluate whether the bank is conducting an appropriate degree of analysis before the customer's loan request is approved to determine whether the customer will be able to manage and repay the credit obligations in accordance with the product's terms. Determine whether the bank's underwriting evaluates whether the customer, after making scheduled payments, will have sufficient remaining funds to cover living expenses.
    - Evaluate the terms of the retail loan product to determine whether product features increase the probability that a customer will be able to manage the repayment obligation.
      - In the case of an installment loan, consider whether monthly installment payments are scheduled over a reasonable period of time to allow a customer to manage repayment obligations appropriately.

26. The bank should evaluate the individual's willingness to repay, which is typically demonstrated by past performance on financial obligations.

    - Determine whether the bank's policies and procedures require an assessment of the customer's financial capacity and willingness to pay before the customer is offered a credit product.
    - Evaluate the sources of information used to assess an individual's creditworthiness. These information sources vary by bank or by product.
      - Determine whether the bank collects and evaluates sufficient information to measure an individual's financial capacity to repay the loan according to its terms, while leaving sufficient disposable income or assets after satisfying other outstanding financial obligations, including living expenses.
      - Determine what information sources the bank relies on to evaluate an individual's creditworthiness and the extent to which the bank relies on that information solely or in conjunction with other forms of information.
        - Evaluate whether the bank relies on information the customer provides on a loan application.
        - Evaluate whether the bank evaluates information about the customer provided by a credit bureau.

[60] Refer to footnotes 12.

- Evaluate whether the bank relies on a credit score. Banks may use credit scores or credit bureau information to project the probability of future payment performance based on past experience, but are not required to do so.
- Evaluate whether the bank relies on a proprietary scoring model and, if so, determine what factors and information are considered in the model. (**Note:** Most banks use a combination of data sources, relying on bureau data to gauge credit experience and performance and the application to gather information not available on a credit report, such as income, assets, housing expense (own or rent), and time on the job).
- Evaluate whether the bank relies on an evaluation of a customer's account behavior based on inflows and outflows through deposit accounts.

27. Assess how the underwriting standards management developed for consumer retail credit products affect credit risk and the bank's risk profile.

    - Evaluate projected and actual delinquencies associated with the product and the impact on asset quality, earnings, capital, and liquidity.
    - Assess the level of losses and determine the extent of the impact on capital and assets. (**Note:** Weak underwriting standards and practices can lower the quality of the portfolio, as evidenced by delinquencies, losses, and adverse classifications.)
    - Evaluate the proportion of unsecured retail credit loans to total loans and to capital.
    - Evaluate the proportion of income and expenses associated with these products to the bank's net income.

28. Document findings and draw conclusions from the review of the bank's installment lending policies. Examiner conclusions on the quality of installment lending underwriting policy standards should be used to complete the appropriate Credit Underwriting Assessment in Examiner View as applicable. (Updated June 16, 2016)

Product Costs and Use

29. Verify that the bank arrives at all charges and fees on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding, or discussion with other banks or their officers. Determine whether charges and fees are established by a decision-making process through which the bank considers the following factors:

    - Cost the bank incurs in offering and providing the service.
    - Deterrence of customer misuse of banking services.
    - Enhancement of the bank's competitive position in accordance with the bank's business plan and marketing strategy.
    - Maintenance of the bank's safety and soundness.

30. Assess the quantity, quality, and sustainability of earnings from retail credit lending.

    - Determine whether underwriting policies for the product require the bank to consider income or assets and debts.

- Determine the retail credit loan portfolio's contribution to corporate earnings and the expected future contribution.
  - Review executive management monthly and/or quarterly performance and portfolio quality MIS reports.
  - Review historical trends, including changes in the product contributions.
  - Review financial projections and budget and plan variances.
  - Review significant income and expense components and measures. Items reviewed should include noninterest income (fees and other add-ons), marketing expense, charge-offs, net interest margin, and risk-adjusted yield.
  - Evaluate the methodologies, assumptions, and documentary support for the bank's planning and forecasting processes. Determine whether material changes are expected in any of the key income and expense components and measures.
  - Determine management's return on assets, return on managed assets, and return on equity hurdles and the actual returns as of the examination date. (**Note:** Asset-based measures are typically more meaningful for comparison because banks allocate capital differently.)
- Determine whether the bank appropriately recognizes uncollectible accrued interest and fees through the ALLL, through a separate interest and fee reserve, or through cash income recognition.
- Review with management the bank's stress test and discuss potential earnings volatility through an economic cycle to assess sustainability. If the bank does not perform stress testing, discuss whether and how management prices loans to withstand economic downturns.
- Determine whether the bank's cost accounting system is capable of generating profit data by product, segment (including grade), channel, and account.
- Assess the profitability of each retail credit product.
  - For each product, review profitability by credit score band, credit grade, sub-portfolio, segment (e.g., LTV differences), and vintage, as appropriate.
  - Compare actual results with projections and discuss variances with management.
- Evaluate profitability by channel.
  - Through discussions with the examiner responsible for third-party management, determine profitability generated through the various channels (e.g., dealers, brokers, and third-party originators).
  - Compare the profitability of the loans generated by the various channels.
- Determine the adequacy of the pricing method.
  - Review the pricing strategy, pricing method, and pricing model, if applicable.
  - Review the major assumptions used in the pricing method and assess reasonableness. Be alert to differences in assumptions by product and channel.
  - Determine whether pricing is driven by risk, capital, or some other allocation method or hurdle and how much, if any, it is driven by the competition.
  - Determine whether the pricing method incorporates a realistic break-even analysis and whether the analysis reflects the true costs of premature reductions (prepayment).
  - Review the pricing matrix by product.
- Assess the adequacy of planning, reporting, and analysis with respect to prepayment. Specifically, determine whether management identifies the volume and trends of

accounts with high interest rates relative to market or low introductory rates to determine exposure and impact on earnings.
- Develop conclusions with respect to the quantity, quality, and sustainability of earnings.

31. Develop conclusions about whether marketing activities are consistent with the bank's business plans and whether systems are in place before new products or marketing initiatives are rolled out.

32. Determine whether, throughout new product development processes, the appropriate functional areas (e.g., risk management, finance, operations, IT, legal, and compliance) are involved so that associated risks are properly identified and controlled.

Credit Terms and Methods of Payment

Note: This objective does not apply to interest-only unsecured consumer retail credit products, such as unsecured interest-only lines of credit, or to skip-a-pay options on credit cards. For further details on skip-a-pay options in the credit card context, please refer to the "Credit Card Lending" booklet of the *Comptroller's Handbook*.

33. Test a sample of products to determine whether the bank structures credit terms to amortize over a reasonable period of time to reduce the principal balance. For a sample of loans to be verified,

    - check notes to confirm principal reduction with each payment.
    - assess whether the term of the loan allows for reasonable principal reduction. Principal reduction should be sufficient to reduce outstanding indebtedness but not so high that the indebtedness affects the borrower's ability to repay the loan.

33. Obtain a copy of the bank's lending policies and procedures. Assess the adequacy and soundness of the policies and procedures, focusing on the main criteria used in the decision-making process and, if applicable, the verification processes used to confirm application or transaction information. Evaluate

    - permissible types of loans.
    - lending authority and limits and the exception approval process.
    - limits on concentrations of credit (e.g., product, geographic, broker, dealer, and score band).
    - credit underwriting criteria, including measurements of the borrower's capacity to repay the loan (e.g., debt-to-income ratios) and treatment of derogatory credit bureau items.
    - credit scorecard cutoffs and tolerances for overrides.
    - borrower credit grade definitions (e.g., A, B, and C).
    - repayment terms (e.g., duration, amortization schedule, and pricing).
    - exception and override processes, criteria, and tracking.

34. Has the bank conditioned the credit product on the customer's repayment by preauthorized electronic fund transfers?[61]

    - Does the product offer a reduced annual percentage rate or other cost-related incentive to induce the customer to accept an automatic repayment feature?
    - If so, does the bank offer other reasonable loan repayment options for the type of credit involved?
    - Does the bank require the automatic repayment of an overdraft credit balance under an overdraft credit plan?

Credit Reporting

35. Refer to the examination procedures for the FCRA contained in OCC Bulletin 2008-28, "Section 623 Furnishers of Information"; OCC Bulletin 2009-23, "Fair Credit Reporting: Accuracy and Integrity of Consumer Report Information and Direct Consumer Dispute Regulations and Guidelines" (for national banks); and to the Office of Thrift Supervision *Examination Handbook*, section 1300, "Fair Credit Reporting Act," and related "Program" (for FSAs).

36. Determine whether the bank reports both positive and negative credit information to the credit bureaus.

37. Evaluate whether the bank's disclosures inform the customer that repayment information is reported to credit bureaus.

Ongoing Monitoring and Risk Assessments

Note: To address any identified risks, the bank should take appropriate actions, including reassessing customer creditworthiness; adjusting credit terms, fees, or limits; suspending or terminating the credit feature; or closing accounts. The bank should consider the significance of revenue from a particular product and monitor for any undue reliance on the fees the product generates.

38. Determine whether management monitors for potential risks, such as credit, compliance, operational, and reputational risks, for retail credit, and determine processes or procedures the bank uses to monitor for such risks.

39. Determine what methods or approaches the bank uses in addressing risks that retail credit products present. For instance, the bank may reassess customer creditworthiness; adjust credit terms, fees, or limits; suspend or terminate the credit feature; or close accounts.

40. Determine whether management monitors the volume of and revenue from retail credit products, as well as changes in customer use.

[61] Refer to 12 CFR 1005.10(e)(1), "Compulsory Use: Credit," and related staff commentary.

41. Determine whether management monitors for undue reliance on fees generated by consumer retail credit products for its revenue and earnings.

42. Obtain feedback from other examiners assigned to the retail credit examination regarding the adequacy of reports available.

Management Oversight

43. Discuss with management changes made or planned since the prior supervisory activity for retail credit products and operations, including

    - growth overall and in individual products.
    - portfolio product mix.
    - new products.
    - marketing or acquisition channels (e.g., direct, mail, telemarketing, Internet, and third-party originators).
    - expansion into new markets and trade areas.
    - new or expanded third-party loan generation or servicing arrangements.
    - underwriting, risk selection criteria, and portfolio quality.
    - monitoring and risk management processes.
    - models used to underwrite or manage the portfolio, if any.
    - loan systems, including underwriting, servicing, and collection platforms.

44. Determine the adequacy and frequency of MIS reports by bank management in the oversight of existing products and new products and services and in the assessment of product use for retail credit. Assess the adequacy of MIS and reports with respect to providing management with the necessary information to monitor and manage all aspects of retail credit lending. Determine whether

    - adequate processes exist to ensure data integrity and report accuracy.
    - key management reports are clearly labeled, dated, maintained, and updated.
    - reports are produced to track volume and performance by product, channel, or marketing initiative.
    - reports are available to track performance trends, delinquency, and quality.

45. Assess whether the bank has an over-reliance on fee income from any single retail credit product. Evaluate whether the bank considers the significance of fee income from a particular product and monitors for undue reliance on fees generated by that product for its revenue and earnings.

46. Evaluate the management and planning process and measures the bank uses to determine success and profitability for retail credit lending. Specifically,

    - determine whether retail credit lending objectives are consistent with the bank's strategic plan and whether the objectives are reasonable in light of the bank's resources, expertise, product offerings, and competitive environment.

- determine whether marketing plans and budgets are consistent with the objectives of the bank's strategic plan.
- evaluate the adequacy of the planning process (growth, financial, and product-related), including the adequacy and timeliness of revisions when warranted by the portfolio performance and new developments.
- determine the board's risk appetite with respect to risk and return objectives (e.g., return on assets, return on equity, or return on investment) or credit performance hurdles (e.g., delinquency, credit loss, or risk score tolerances).
- assess the qualifications, expertise, and staffing levels of management and staff in view of existing and planned lending activities.

47. Review and assess the adequacy of the bank's policies, procedures, and practices. Specifically,

    - determine whether loan policies are approved by the board at inception and included in annual policy reviews thereafter.
    - identify significant changes in underwriting criteria and terms, how credit scoring models are used, account management activities, and collection practices and policies. Specifically,
      - determine the effect of those changes on the portfolio and its performance.
      - determine whether underwriting policies provide appropriate guidance on assessing whether the borrower's capacity to repay the loan is based on consideration of the borrower's income, financial resources, and debt service obligations.
    - if the bank uses credit scoring (e.g., bureau, pooled, or custom),
      - determine how the bank ensures that the model is appropriate for the target population and product offering.
      - assess the reasonableness of the process used to establish cutoffs and determine whether management changed the cutoffs between examinations and, if so, the implications for portfolio quality and performance.
      - determine whether the policy provides for model monitoring and validation.
    - determine how policies and changes are communicated to staff and assess the adequacy of the process.

    Document findings and draw conclusions from the review of the bank's installment lending policies. Examiner conclusions on the quality of installment lending underwriting policy standards should be used to complete the appropriate Credit Underwriting Assessment in Examiner View, if applicable. (Updated June 16, 2016)

Product Development

48. Assess new product development. Specifically,

    - discuss with management the new product development process.
    - determine whether there are written guidelines for what constitutes a new product.
    - review new product proposals and plans approved since the last examination.

- determine whether the appropriate functional areas (e.g., risk management, finance, operations, IT, legal, and compliance) are involved throughout the development process so that associated risks are properly identified and controlled. In addition, determine whether the constituents remain involved during implementation.
- evaluate systems planning to determine whether MIS and reporting needs are adequately researched and developed before new products are rolled out. Specifically, determine whether the systems and reports are adequate to supervise and administer new products.
- evaluate the adequacy of the review and approval processes for new products.
- determine whether management, including appropriate legal and compliance personnel, reviews marketing materials during product development and implementation to avoid deceptive or misleading advertising, terms, and disclosures.
- determine whether the planning process adequately identifies and addresses the risks, operational needs, and systems support associated with different solicitation methods and channels, including direct applications, indirect (broker/dealer), loan-by-phone, and the Internet.
- review internal audit policies, procedures, programs, reports, work papers, and issues.

49. Develop conclusions about whether marketing activities are consistent with the bank's business plans, strategic plans, and risk appetite objectives and whether appropriate controls and systems are in place before new products or marketing initiatives are rolled out.

Account Management, Charge-Offs, and Collections

Note: Account management activities are used extensively in open-end lending for products such as credit cards, other unsecured lines of credit, and home-equity lines. Banks, however, should actively monitor and manage existing closed-end accounts as well. Therefore, the following procedures are targeted specifically to closed-end products.

50. Obtain and evaluate bank account management, charge-off, and collection policies and procedures.

51. Determine whether bank systems are capable of aggregating the entire loan relationship by customer (multiple loan accounts by product and in total) for the purpose of customer-level account management. If so, determine the extent to which the bank uses that capability.

52. Determine whether the bank uses credit scoring for nondelinquent account management. If so, identify the type of scoring used (e.g., refreshed bureau, behavior, or bankruptcy scores), the frequency of obtaining updated scores, and how the scores are used in the account management process.

53. If the bank does not use or augment scoring, determine how management reviews the bank's account base for changes in credit quality (e.g., bureau warning screens or

delinquent property tax notifications) or to identify marketing opportunities. Determine whether the process is reasonable, including any actions taken based on the reviews.

54. Review and assess the adequacy of written policies and procedures, including disclosure requirements, that govern account management activities. Account management activities may include

    - payment holiday programs (e.g., skip-a-pay).
    - pay-ahead programs.
    - customer service extensions and deferrals.
    - retention programs. (**Note:** Retention programs are critical to relationship management and attrition. Be alert to whether the programs are proactive or reactive and to how management measures performance.)

55. Determine the adequacy of the bank's administration of account management programs. Specifically,

    - review the adequacy of the program or strategy approval process and assess whether all interested units are appropriately represented (e.g., risk management, marketing, customer service, compliance, IT, and finance).
    - assess whether the analyses performed to support new and existing strategies are adequate and appropriately consider all possible effects of the proposed actions (e.g., the effects on credit performance, attrition and adverse retention, earnings, and compliance and reputation risks). In addition, determine whether analyses properly consider the impact of overlapping or repeat account management strategies.
    - determine whether the bank performs adequate testing of strategies that have the potential for significant impact on credit performance and earnings before full implementation.
    - determine whether the bank has developed and implemented appropriate MIS reports before initiating testing and strategies and that management regularly monitors and analyzes actual versus expected results.
    - assess the adequacy and timeliness of management's response to poorly performing strategies as well as the actions taken when strategies perform significantly better than expected.

56. Assess the reasonableness of the bank's account management strategies, evaluating the scope and frequency of each strategy employed, the inclusion and exclusion criteria, the various strategy components and outcomes, and adherence to the approved proposals and written policies and procedures. (**Note:** Payment holiday programs should only be offered to the most creditworthy customers.)

57. Review the policies that govern imposing and waiving late, extension, and other fees. Determine whether the policies are reasonable and applied in a nondiscriminatory manner and whether the effect on performance is adequately monitored, analyzed, and addressed.

58. Based on the significance of the bank's use of account management activities, determine whether account sampling is warranted.

59. Develop conclusions with respect to the effectiveness of activities and strategies used to enhance performance and profitability of existing, nondelinquent accounts or portfolios and any implications for the quality of the portfolio and the quantity and direction of risk. Clearly document all findings. Evaluate the effectiveness of the collection function, including the collection strategies and programs employed, to better assess the quality of the portfolio and the quantity and direction of credit risk.

60. Perform Collection Procedures as warranted.

Compliance With Consumer Protection Laws and Regulations

Note: Depending on the focus of any particular review, the examiner undertaking reviews for compliance with consumer protection laws should further consult the relevant *Consumer Compliance* booklet of the *Comptroller's Handbook* for more information and complete examination procedures. While the following procedures include some consumer compliance legal requirements, they are not intended to be comprehensive.

61. Verify that the bank has sufficient policies, procedures, and staff to comply with consumer protection laws and regulations concerning unsecured consumer retail credit products. Verify that related bank activities are executed in conformity with board-approved strategies and processes and that the activities comply with statutes and regulations.

    - Determine how policies and changes are communicated to staff and assess the adequacy of the communication process.
    - Evaluate the bank's processes for establishing policy exception criteria and limits and for monitoring and approving underwriting policy exceptions (e.g., underwriting standards or loan terms).
    - Determine the control processes to track and monitor policy adherence (e.g., QA, MIS reports, and audit) and assess the adequacy of those processes.

62. Determine whether marketing activities are consistent with relevant consumer protection laws and related policies and procedures.

    - Review the process for developing and implementing marketing plans, with particular attention to whether the relevant functional areas (e.g., compliance and legal) are involved throughout the process.
    - Develop conclusions about whether marketing activities are consistent with consumer protection laws and related policies and procedures and whether appropriate controls and systems are in place before new products or marketing initiatives are rolled out.

63. Assess new product development. Specifically,

    - determine whether there are written guidelines for what constitutes a new product.
    - evaluate the adequacy of the review and approval processes for new products.
    - review new product proposals and plans approved since the last examination.
    - determine whether the appropriate functional areas (e.g., compliance and legal) are involved throughout the development process to ensure that associated risks involving violations of relevant consumer protections laws are properly identified and controlled.
    - determine whether management, including appropriate legal and compliance personnel, reviews marketing materials during product development and implementation to avoid deceptive or misleading advertising, terms, and disclosures.

64. Determine whether management considers customer complaints and complaint resolution in the risk management processes. If not previously completed, obtain copies of complaints reported to the OCC's Customer Assistance Group and bank customer complaint logs. Evaluate the information for significant issues and trends. (**Note:** Complaints serve as valuable early warning indicators for compliance.)

65. Evaluate a sample of consumer disclosures for compliance with applicable consumer protections laws and regulations.

Other Controls

66. Confirm that there is an adequate process to reconcile major balance sheet categories and general ledger entries daily.

67. Identify and determine the adequacy of the bank's process for regularly evaluating data integrity and MIS accuracy.

    - Review the scope and frequency of internal audit or other reviews of MIS accuracy.
    - Review the findings of the most recent reviews.

68. Develop conclusions with respect to the adequacy of the bank's processes for identifying, measuring, monitoring, and controlling risk by reviewing the effectiveness of risk management and other control functions. Clearly document all findings.

Conclusions

Conclusion: The aggregate level of each associated risk is (low, moderate, or high).
The direction of each associated risk is (increasing, stable, or decreasing).

Objective: To determine, document, and communicate overall findings and conclusions regarding the examination of installment lending.

1. Determine preliminary examination findings and conclusions and discuss with the EIC, including

   - quantity of associated risks (as noted in the "Introduction" section of this booklet).
   - quality of risk management.
   - aggregate level and direction of associated risks.
   - overall risk in installment lending.
   - Credit Underwriting Assessment findings and conclusions, if applicable. (Updated June 16, 2016)
   - violations and other concerns.

Summary of Risks Associated With Installment Lending				
Risk category	**Quantity of risk**	**Quality of risk management**	**Aggregate level of risk**	**Direction of risk**
	(Low, moderate, high)	(Weak, insufficient, satisfactory, strong)	(Low, moderate, high)	(Increasing, stable, decreasing)
Credit				
Operational				
Compliance				
Strategic				
Reputation				

2. If substantive safety and soundness concerns remain unresolved that may have a material adverse effect on the bank, further expand the scope of the examination by completing verification procedures.

3. Discuss examination findings with bank management, including violations, recommendations, and conclusions about risks and risk management processes. If necessary, obtain commitments for corrective action.

4. Compose conclusion comments, highlighting any issues that should be included in the report of examination. If necessary, compose a matters requiring attention comment.

5. Complete the applicable Credit Underwriting Assessment in Examiner View for installment lending or targeted areas, if included in the examination scope. (Updated June 16, 2016)

6. Update the OCC's information system and any applicable report of examination schedules or tables.

7. Write a memorandum specifically setting out what the OCC should do in the future to effectively supervise installment lending in the bank, including time periods, staffing, and workdays required.

8. Update, organize, and reference work papers in accordance with OCC policy.

9. Ensure any paper or electronic media that contain sensitive bank or customer information are appropriately disposed of or secured.

Internal Control Questionnaire

An internal control questionnaire (ICQ) helps an examiner assess the bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment.

Review the bank's internal controls, policies, practices, and procedures for making and servicing installment loans. The bank's system should be documented in a complete and concise manner and should include, if appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

Consumer Loan Policies

1. Has the board adopted written consumer loan policies that establish

    - procedures detailing loan underwriting guidelines, such as debt-to-income ratios, LTV ratios, job stability requirements, credit history requirements, acceptable collateral, and loan terms for each type of loan?
    - standards for determining credit lines?
    - minimum standards for documentation?

2. Does the board review consumer loan policies at least annually to determine whether they are compatible with the current business plan and the marketplace?

Segregation of Duties

3. Are persons who perform or review the preparation and posting of supplementary customer loan records prohibited from

    - issuing official checks or drafts singly?
    - handling cash or checks?

4. Are persons who perform or review the preparation and posting of interest records prohibited from

    - issuing official checks or drafts singly?
    - handling cash or checks?

5. Are persons who receive and investigate inquiries about loan balances prohibited from also handling cash and checks?

6. Are persons who subsequently review or test documents supporting recorded credit adjustments prohibited from also handling cash and checks?

7. Are persons who investigate reconciling items prohibited from also handling cash?

Loan Approval

8. Are loans approved only by authorized officers within specified, board-approved limits?

9. When amounts are significant (as defined by the board), does the bank require two authorized signatures to effect approval or a status change in an individual customer account?

Physical Security of Documents

10. If secured property is a marketable security or small personal property, does the bank have physical control of the security or property? If so, is it

    - under the supervision of an officer?
    - kept under dual control?
    - kept in a fireproof container?
    - inventoried periodically and maintained in a log?
    - released under controlled procedures and in a timely manner once proof of loan payoff has been received?

Collateral

11. Does the bank maintain records that

    - detail the complete description of collateral pledged?
    - are signed by the customer?

12. When collateral value is high, does the bank require that two officers review and approve the release?

Balancing of Subsidiary Ledgers to the General Ledger

13. Does the bank reconcile at least monthly the subsidiary customer loan records with the appropriate general ledger accounts?

Disbursements of Loan Proceeds

14. Does the bank segregate disbursement and loan approval responsibilities?

Operating Review System

15. Has the bank developed procedures for monitoring compliance with established controls?

16. Has the bank assigned employee(s) to

- review new loan documentation?
- determine proper segregation of duties and prohibit loan officers from processing loan payments?
- recompute the amount of discount on new loans?
- review entries to unearned discount or income accounts?
- determine accurate and prompt posting of payments?
- test check postings to the general ledger at least weekly?

Other

17. Does the bank maintain a daily record summarizing loan transaction details, e.g., loans made, payments received, and interest collected, to support applicable general ledger entries?

18. Does operating management produce and review an exception report that encompasses extensions, renewals, or any factors that will result in a change in customer account status?

19. Does management establish collection policies so that

    - delinquency notice is sent before a loan is 30 days past due?
    - collection effort is intensified when a loan becomes two payments past due?
    - records of collection efforts are maintained in the customer's file?

Conclusion

20. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above? (Explain negative answers briefly and indicate conclusions as to their effect on specific examination or verification procedures).

21. Based on the answers to the foregoing questions, internal control for installment lending is considered (strong, satisfactory, insufficient, or weak).

Verification Procedures

Verification procedures are used to verify the existence of assets and liabilities or test the reliability of financial records. Examiners generally do not perform verification procedures as part of a typical examination. Rather, verification procedures are performed when substantive safety and soundness concerns are identified that are not mitigated by the bank's risk management processes and internal controls.

Note: Examiners normally do not need to do extensive verification. These procedures are appropriate, however, when the bank has inadequate audit coverage of retail lending activities or when fraud or other irregularities are suspected.

1. Test the additions of the trial balances and the reconciliation of the trial balances to the general ledger. Include loan commitments and other contingent liabilities.

2. After selecting loans from the trial balance by using an appropriate sampling technique, do the following:

    - Prepare and mail confirmation forms to borrowers. (Loans serviced by other institutions, either whole loans or participations, are usually confirmed only with the servicing institution. Loans serviced for other institutions, either whole loans or participations, should be confirmed with the buying institution and the borrower. Confirmation forms should include borrower's name, loan number, the original amount, interest rate, current loan balance, borrowing base, and a brief description of the collateral.)
    - After a reasonable time, mail second requests.
    - Follow up on any unanswered requests for verification or exceptions and resolve differences.
    - Examine notes for completeness and compare date, amount, and terms with trial balance.
    - In the event notes are not held at the bank, request confirmation by the holder.
    - Check to see whether required officer approvals are on the note.
    - Check to see whether note is signed, appears to be genuine, and is negotiable.
    - Compare collateral held in loan files with the description on the collateral register.
    - If the loan is secured, determine whether the proper collateral documentation is on file.
    - Determine whether advance rates and LTVs are reasonable and in line with bank policy.
    - List all collateral discrepancies and investigate.
    - Determine whether any required insurance coverage is adequate and whether the bank is named as loss payee.

3. Review disbursement ledgers and authorizations and determine whether authorizations are signed in accordance with terms of the loan agreement.

4. Review accounts with accrued interest by

    - reviewing and testing procedures for accounting for accrued interest and for handling adjustments.
    - scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

5. Using a list of nonaccruing loans, check loan accrual records to determine whether interest income is being recorded.

6. Obtain or prepare a schedule showing the monthly interest income amounts and the retail loan balance at each month end since the last examination and

    - calculate yield.
    - investigate any significant fluctuations or trends.

Appendixes

Appendix A: Transaction Testing

Overview

Examiners should perform testing procedures when the EIC determines that the OCC should verify a bank's consistency with its own policies and procedures or with supervisory policies, regulations, or laws. The EIC also institutes testing when the OCC should assess the bank's risk selection, the accuracy of its MIS, or the accuracy of its loan accounting and servicing. Testing procedures should usually be performed periodically on portfolios or targeted segments of the portfolios when there is elevated risk (e.g., subprime lending), an increase in delinquency and loss rates, new lines of business, new acquisition channels, or rapid growth, or when loan review or audit is inadequate.

These procedures recommend judgmental sample sizes. The sample size and targeted portfolio segment may be modified to fit the circumstances. The sample should be large enough to reach a supportable conclusion. Increase the sample size if questions arise and more evidence is needed to support the conclusion.

Examiners may want to consider using a statistical sampling process for reaching conclusions on an entire portfolio. Performing statistically valid transaction testing on portfolios of homogeneous retail accounts is extremely effective. The benefits of statistical sampling allow the examiner to quantify the results of transaction testing and state with a statistically valid confidence that the results are reliable. For additional information, consult the "Sampling Methodologies" booklet of the *Comptroller's Handbook.*

Examiners conducting testing should be alert for potential discriminatory, unfair, deceptive, abusive, or predatory lending practices (e.g., lending predominantly on the value of collateral rather than the borrower's ability to service the debt, making high-cost loans, or providing misleading disclosures). If weaknesses are found or other concerns arise, consult the bank's EIC or compliance examiner.

Note: For additional information, refer to the "Fair Lending" booklet of the *Comptroller's Handbook* and to OCC Advisory Letters 2002-3, 2003-2, and 2003-3.

Suggested Transaction Testing Samples

Note: Sample sizes are suggestions only. The sample should be large enough to reach a supportable conclusion. Expand the sample size if issues are found or more evidence is needed to support a conclusion.

Underwriting

Objective: To determine the quality of new loans and risk selection. To determine adherence to lending policy, underwriting standards, and pricing standards.

Sample size: 30	Accounts booked in last 90 days. • Include coverage of all significant product types. • Include all or target certain acquisition channels. • Include different price points.

Sample size: 10 from **each** significant third-party origination channel	Accounts approved and booked in last 90 days. • Include all significant third-party loan originators, including dealers and brokers.

Sample size: 30	Applications declined in last 90 days. • Include coverage of all significant product types. • Include all or target certain acquisition channels. • Focus on applications not automatically denied if credit scoring is used.

Lending Policy Exceptions

Objective: To evaluate the quality and appropriateness of exceptions to lending policy.

Sample size: 30	Accounts booked in last 90 days. • Include all exception codes. • Include coverage of all significant product types. • Include loans with exceptions from all significant third-party loan originators, including dealers and brokers. • If exception coding is deficient, filter new loans for exceptions to LTV, debt-to-income, credit history, etc. and select sample.

Overrides

Objective: To evaluate the quality and appropriateness of low-score overrides.

Sample size: 30	Accounts booked in last 90 days. • Select loans that scored below cutoff and were approved. • Include all score override reason codes. • Include loans in all score bands below the cutoff.

Collection Activities

Objective: To evaluate appropriateness of collection activities and consistency with OCC Bulletin 2000-20.

Note: Refer also to the checklist in appendix C.

Payment Extensions and Deferrals

Sample size: 30	Closed-end loans that received loan modifications in last three months that brought the loans to current status. • Include loans that were two payments or more past due. • Check consistency with OCC Bulletin 2000-20 and compliance with bank policies.

Rewrites and Renewals

Sample size: 30	Closed-end loans that were rewritten and renewed in the last three months. • Include loans that were 30 days or more past due. • Check consistency with OCC Bulletin 2000-20 and compliance with bank policies.

Workout and Forbearance Programs

Sample size: 30	Closed-end loans in 1) external workout programs (e.g., CCC) and 2) internal workout programs. • Sample each product type, e.g., auto and home equity loans. • Include loans with interest rate and payment amount modifications. • Verify compliance with internal policies and procedures. • Evaluate the reasonableness of the program, e.g., qualifying criteria, terms, and collectability.

Bankruptcy

Sample size: 30 per loan type	Closed-end loans coded as bankrupt as of exam date. • Include borrowers in chapter 7 and chapter 13. • Assess consistency with OCC Bulletin 2000-20 and compliance with bank policies.

Were Past Due, Now Current

Sample size: 30	Closed-end loans that were 60 days or more past due as of three months ago but are current in the next month. • Check consistency with OCC Bulletin 2000-20 and compliance with bank policies. • Determine how each loan returned to current status and its appropriateness. • Assess the accuracy of the loan accounting system and delinquency reporting. • Consider the impact of any irregularities on roll-rates and loan loss method.

Exceptions to Charge-Off Policy

Sample size: 30	Closed-end loans more than 120 days past due as of exam date. • Include loans from each product type. • Verify consistency with OCC Bulletin 2000-20 and compliance with bank policies. • Evaluate whether exceptions to FFIEC policy are appropriate.

Charge-Off Postmortem

Sample size: 30	Recently charged-off loans. • Include loans from each product type. • Verify consistency with OCC Bulletin 2000-20 and compliance with bank policies. • Review borrower, payment, and collection histories to determine whether actions taken pre-charge-off were reasonable or whether the practices deferred loss recognition. • Evaluate whether exceptions to FFIEC policy are appropriate.

Fraud

Objective: To assess adherence to policy, determine appropriateness of practices, and determine timeliness of charge-off policies.

Sample size: 30	Closed-end loans identified as fraud, in part or total. • Determine whether accounts identified as fraud are being investigated. • Verify compliance with bank's policy and procedures, including what is considered fraud. • Determine whether fraud losses are properly identified as fraud losses rather than as credit losses. • Determine compliance with charge-off time frames (within 90 days of discovery).

Debt Waiver

Objective: To verify how the product is managed.

Sample size: 30	Closed-end loans with DCCs. • Include loans in both pending and activated status. • Determine whether the accounts are properly managed, e.g., activation process, accounting, re-aging, and MIS. • Verify compliance with bank's policy and procedures. • Verify compliance with 12 CFR 37 (national banks).

Sample size: 30	Closed-end loans with DSAs. • Include loans in both pending and activated status. • Determine whether the accounts are properly managed, e.g., activation process, accounting, re-aging, and MIS. • Verify compliance with bank's policy and procedures. • Verify compliance with 12 CFR 37 (national banks).

Appendix B: Sample Request Letter

Please provide the following information for installment lending activities as of the close of business on (DATE), unless otherwise indicated. Information in an electronic format is preferred. If submitting hard copies, please prominently mark any information or documentation that is to be returned to the bank.

The OCC's intent is to request information that can be easily obtained. If you find that the information is not readily available or requires significant effort on your part to prepare, please contact us before compiling the data.

Please note that this list is not all-inclusive and that we may request additional items during the course of our examination.

General

1. Summary of each installment loan product offered and a brief description of characteristics and terms. Include descriptions of debt waiver products offered, if any. Also, include marketing or acquisition channels used (e.g., direct, Internet, mail, and third-party originators), if applicable.

2. Descriptions of any new or expanded products or marketing initiatives since the last examination and any upcoming plans.

3. Descriptions of any third-party loan generation (e.g., dealers and brokers) or servicing arrangements (e.g., collection agencies).

4. Descriptions of any retail portfolios acquired since the last examination, including due diligence reports.

Management and Supervision

Note: During the supervisory activity, examiners may request, review, and discuss individual manager's performance appraisals.

5. Organization chart(s) for the department's current structure. Include all key managers, the number of people in each department, and approved but unfilled positions.

6. List of primary contacts, including contact numbers.

7. Job descriptions and brief résumé or work experience summary for all key managers.

8. List of board and relevant senior management committees that provide area oversight, including a list of members and meeting schedules.

9. Minutes of board and relevant senior management committees for most recent full year and year-to-date. Include any relevant reports provided to the committees.

10. Most recent strategic plan with details of any assumptions used to prepare the plan. Include marketing plans and forecasts for installment lending products.

11. Board-approved risk appetite statement.

12. Summaries of all incentive programs in effect in the department.

13. List of all key reports management uses to monitor the business, including frequency, distribution, and the person or unit responsible for report preparation.

Financial Performance

14. Financial and profitability performance indicators for the department from the most recent year-end and for year-to-date. Copies of balance sheets and income statements from most recent year-end and for year-to-date, including budget data for comparison purposes.

15. Most recent budget, with details of any assumptions used to prepare it. Include any year-to-date budget variances and plan revisions as of the examination date.

16. Profitability reports for each major product as of the examination date and the most recent year-end.

17. Summary of any profitability models used and the current rate and fee schedule for each product.

Control Systems (Risk Management, Loan Review, Quality Control, Audit)

18. Relevant reports issued by internal and external audit, QC, compliance management, and loan review since the last examination. Include management's responses.

19. Policies and procedures for major functional areas, including underwriting, account management, collections, loan loss reserves, and QC.

20. A chronology log of significant policy changes and other events relevant to the portfolio's performance.

21. Risk management reports and analyses used to monitor performance of the portfolio and individual products.

22. Loan volume reports by number and dollar amount for the entire portfolio and individual products.

23. Summary of monthly delinquency and net loss reports from the most recent year-end and for the year-to-date for the portfolio and individual products. Also provide any vintage analysis, dynamic delinquency, and loss analysis completed to monitor the portfolio. Include other credit performance analyses the examiner feels are pertinent.

24. Overview of the scorecards used, if any, and a summary of any changes planned.

25. Most recent model validation for each scorecard used.

26. Risk score distributions and migration trends.

27. Most recent loss forecasts.

28. If dealers, brokers, or other third-party originators are used, MIS used to monitor quality of applicants and credit performance of loans sourced from each third party used.

29. Description of controls (e.g., financial and audit requirements) and performance reports used to monitor third parties' quality of service, as well as due diligence criteria used to select third parties for the retail activities.

Underwriting

30. Risk management reports used to monitor and analyze applicant quality and trends. Include application-tracking trend reports for the most recent year-end and year-to-date. Depending on the portfolio, information may include applications submitted, approved, booked, and denied, and underwriting criteria, such as credit grades, LTV, credit score, and debt-to-income distributions or measures.

31. Reports used to track loan officer or underwriter productivity and compliance with policy.

32. Reports used to monitor underwriting policy exceptions and overrides. Include any analyses of subsequent performance by type of exception.

Collections

33. An overview of how the bank's operations conform with OCC Bulletin 2000-20.

34. Volume and trends for loan extensions, including subsequent performance monitoring.

35. Volume and trends of accounts in workout programs (e.g., CCC) or other forbearance programs, including subsequent performance monitoring.

36. Problem loan list with credit risk classifications and criteria for assigning the risk classifications.

37. MIS used to monitor the volume and trends for repossession, as well as remarketing efforts. Include inventory aging and monthly trends for units, dollars, and deficiency loss trends.

38. Loan loss postmortem reviews from the most recent year-end and for year-to-date.

39. MIS reports used to manage and measure the effectiveness of the collection area (e.g., roll-rates, dollars collected, promises to pay).

40. MIS reports detailing the number and dollars of first payment defaults. If available, include monthly reports for the last 12 months.

ALLL

41. Most recent ALLL analysis for the portfolio. Include a complete description of the method and assumptions used.

Other Areas of Interest

42. Customer complaint logs for installment loans since the last examination.

43. Description of litigation, either filed or anticipated, associated with the bank's installment lending activities. Include expected costs or other implications.

44. If debt suspension, debt cancellation, or other cross-sold products are offered, MIS used to monitor product performance. Include information for product penetration, claims rates (approved and denied), reserve method and balances, and profitability.

Transaction Testing

Examiners will conduct transaction testing to verify compliance with the bank's policies and procedures; assess risk selection; determine accuracy of MIS; verify consistency with applicable policies and compliance with laws and regulations; and determine the accuracy of loan accounting and servicing.

45. For each product, provide electronic files that will allow an examiner to select a sample to conduct the testing. The file should be provided in a file compatible with the NCT2 or an Excel worksheet that includes relevant loan information (e.g., account number, customer name, booking date, loan amount, payment information (current payment due, last payment date), loan term, interest rate, delinquency status, risk score, LTV, and repayment capacity measure).

    Notes: If NCT2 is available, examiners are encouraged to use NCT2 sampling capabilities to assist in the transaction testing. Also, examiners may want to inform the bank of the types of transactional testing that may be performed. Examples are included below.

Areas To Be Tested
Loans approved in the last 60 days (since DATE). If credit scoring is used, provide two files, one for accounts not automatically approved and one for accounts automatically approved.
Loans approved in the last 60 days (since DATE) that would have been denied except for an override or exception to policy.
Loans that were 60 days or more past due as of (DATE) but are current as of (DATE).
Loans extended, deferred, or rewritten in (MONTH).
Loans charged off in (MONTH).

Appendix C: Uniform Retail Credit Classification and Account Management Policy Checklist (RCCP Checklist)

Retail Credit Classification and Account Management Policy	Reference	Comments
Retail credit classification and account management policy (RCCP) applicability: • Closed-end credit extended to customers for household, family, and other personal expenditures, includes consumer loans and credit cards. • Loans to customers secured by their personal residence, including first mortgage, home equity, and home improvement loans.		
Note regarding minimum policy guidelines • The RCCP does not preclude examiners from classifying individual loans or entire portfolios regardless of delinquency status or criticizing account management practices that are deficient or improperly managed. If underwriting standards, risk management, or account management standards are weak and present unreasonable credit risk, deviation from the minimum classification guidelines outlined in the policy may be prudent. • Credit losses should be recognized when the bank becomes aware of the loss, but should not exceed the time frames stated in the policy.		
Substandard classification • Does the bank consider closed-end retail loans 90 cumulative days past due substandard? • When the bank does not hold the senior mortgage on a home equity loan, does it consider the loan substandard if it is 90 days or more past due, even if the LTV is 60 percent or less (see note below)? • For loans to borrowers in bankruptcy, does bank appropriately classify the loans as substandard until the borrower reestablishes the ability and willingness to repay for a period of at least six months, even when the bank can clearly demonstrate that repayment is likely to occur? **Note:** The policy states that properly secured residential real estate loans with LTV ratios of 60 percent or less may not need to be classified based solely on delinquency.		
Loss classification • Are unsecured closed-end retail loans charged off in the month they become 120 cumulative days past due? • Are secured closed-end retail loans secured by other than real estate collateral charged off in the month they become 120 cumulative days past due? – If not, are these loans written down to the value of the collateral, less cost to sell, **if** repossession of collateral is assured and in process? • For closed-end loans secured by residential real estate, is a current assessment of value made no later than when the account is 180 days past due? – For such loans, is any loan balance in excess of the value of the property, less cost to sell, charged off?		
Bankruptcy • Are loans in bankruptcy charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the 120- or 180-day time frame (whichever is shorter)?		

Retail Credit Classification and Account Management Policy	Reference	Comments
• Are loans with collateral written down to the value of collateral, less cost to sell? • When a loan's balance is not charged off, does the bank classify it as substandard until the borrower reestablishes the ability and willingness to repay for a period of at least six months?		
Fraudulent loans • Are fraudulent loans classified loss and charged off within 90 days of discovery or within the 120- or 180-day time frame (whichever is shorter)?		
Deceased accounts • Are loans of deceased persons classified loss and charged off when the loss is determined or within the 120- or 180-day time frame (whichever is shorter)?		
Other considerations for classification • Under what conditions would the bank not classify (substandard or loss) a loan in accordance with the policy? **Note:** The policy permits nonclassification if the bank can document that the loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status.		
Partial payments • Does bank require that a payment be equivalent to 90 percent or greater of the contractual payment before counting the payment as a full payment? • As an alternative, does the bank aggregate payments and give credit for any partial payments received? • Are controls in place to prevent both methods above from being used simultaneously on the same credit?		
Re-aging, extensions, deferrals, renewals, and rewrites • Are the above types of activities only permitted when the action is based on a renewed willingness and ability to repay the loan? • Does documentation show that the bank communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan? • Does MIS separately identify the number of accounts and dollar amounts that have been re-aged, extended, deferred, renewed, or rewritten, including the number of times such actions have been taken? • How does the bank monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, rewritten, or placed in a workout program? **Note:** The issues above do not apply to customer-service-originated extensions or program extensions (such as holiday skip-a-pay). Examples of how the bank would determine and document the borrower's willingness and ability to repay could include such items as credit bureau score and data being obtained and reviewed, stated income being verified, and obtaining a "hardship" letter from the borrower.		

Retail Credit Classification and Account Management Policy	Reference	Comments
Closed-end credit (standards, controls, and MIS for each area) • Has the bank adopted and adhered to explicit standards that control the use of extensions, deferrals, renewals, and rewrites? • Do the standards include the following: – Borrower has shown a renewed willingness and ability to repay the loan? – Limits on the number and frequency of extensions, deferrals, renewals, and rewrites? • Are additional advances to finance unpaid interest and fees prohibited? • Does MIS track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite?		

Appendix D: Debt Suspension Agreement and Debt Cancellation Contract Forms and Disclosure Worksheet (National Banks)

Debt Suspension Agreement and Debt Cancellation Contract Forms and Disclosure Worksheet	Compliance Yes/No/NA	Comments
12 CFR 37.6(a), "Content of Short Form of Disclosures," appendix A to part 37, "Short Form Disclosures"		
Product is optional Your purchase of [PRODUCT NAME] is optional. Whether or not you purchase [PRODUCT NAME] will not affect your application for credit or the terms of any existing credit agreement you have with the bank.		
Lump-sum payment of fee **Note:** Applicable if a national bank offers the option to pay the fee in a single payment. Prohibited when the debt subject to the contract is a residential mortgage loan. You may choose to pay the fee in a single lump sum or in [monthly/quarterly] payments. Adding the lump sum of the fee to the amount you borrow will increase the cost of [PRODUCT NAME].		
Lump-sum payment of fee with no refund **Note:** Applicable if a national bank offers the option to pay the fee in a single payment for a no-refund debt cancellation contract. Prohibited when the debt subject to the contract is a residential mortgage loan. You may choose [PRODUCT NAME] with or without a refund provision. Prices of refund and no-refund products are likely to differ.		
Refund of fee paid in lump sum **Note:** Applicable to a national bank when the customer pays the fee in a single payment and the fee is added to the amount borrowed. Prohibited when the debt subject to the contract is a residential mortgage loan. *Either* (1) You may cancel [PRODUCT NAME] at any time and receive a refund; *or* (2) You may cancel [PRODUCT NAME] within _____ days and receive a full refund; *or* (3) If you cancel [PRODUCT NAME] you will not receive a refund.		
Additional disclosures We will give you additional information before you are required to pay for [PRODUCT NAME]. *[If applicable:]* This information will include a copy of the contract containing the terms of [PRODUCT NAME].		
Eligibility requirements, conditions, and exclusions There are eligibility requirements, conditions, and exclusions that could prevent you from receiving benefits under [PRODUCT NAME]. *Either* (1) You should carefully read our additional information for a full explanation of the terms of [PRODUCT NAME] *or* (2) You should carefully read the contract for a full explanation of the terms of [PRODUCT NAME].		

Debt Suspension Agreement and Debt Cancellation Contract Forms and Disclosure Worksheet	Compliance Yes/No/NA	Comments
12 CFR 37.6(b), "Content of Long Form of Disclosures" appendix B to part 37, "Long Form Disclosures"		
Product is optional Your purchase of [PRODUCT NAME] is optional. Whether or not you purchase [PRODUCT NAME] will not affect your application for credit or the terms of any existing credit agreement you have with the bank.		
Explanation of debt suspension agreement **Note:** Applicable if the contract has a debt suspension feature. If [PRODUCT NAME] is activated, your duty to pay the loan principal and interest to the bank is only suspended. You must fully repay the loan after the period of suspension has expired. *[If applicable:]* This includes interest accumulated during the period of suspension.		
Amount of fee *For closed-end credit*: The total fee for [PRODUCT NAME] is ___.		
Lump-sum payment of fee **Note:** Applicable if a national bank offers the option to pay the fee in a single payment. Prohibited when the debt subject to the contract is a residential mortgage loan. You may choose to pay the fee in a single lump sum or in [monthly/quarterly] payments. Adding the lump sum of the fee to the amount you borrow will increase the cost of [PRODUCT NAME].		
Lump-sum payment of fee with no refund **Note:** Applicable if a national bank offers the option to pay the fee in a single payment for a no-refund DCC. Prohibited when the debt subject to the contract is a residential mortgage loan. You have the option to purchase [PRODUCT NAME] that includes a refund of the unearned portion of the fee if you terminate the contract or prepay the loan in full prior to the scheduled termination date. Prices of refund and no-refund products may differ.		
Refund of fee paid in lump sum **Note:** Applicable to a national bank when the customer pays the fee in a single payment and the fee is added to the amount borrowed. Prohibited when the debt subject to the contract is a residential mortgage loan. *Either* (1) You may cancel [PRODUCT NAME] at any time and receive a refund; *or* (2) You may cancel [PRODUCT NAME] within ____ days and receive a full refund; *or* (3) If you cancel [PRODUCT NAME] you will not receive a refund.		

Debt Suspension Agreement and Debt Cancellation Contract Forms and Disclosure Worksheet	Compliance Yes/No/NA	Comments
Termination of product *Either* (1) You have no right to cancel [PRODUCT NAME]; *or* (2) You have the right to cancel [PRODUCT NAME] in the following circumstances: _____. And *Either* (1) The bank has no right to cancel [PRODUCT NAME]; *or* (2) The bank has the right to cancel [PRODUCT NAME] in the following circumstances: _____.		
Eligibility requirements, conditions, and exclusions There are eligibility requirements, conditions, and exclusions that could prevent you from receiving benefits under [PRODUCT NAME]. *Either* (1) The following is a summary of the eligibility requirements, conditions, and exclusions [the bank provides a summary of any eligibility requirements, conditions, and exclusions]; *or* (2) You may find a complete explanation of the eligibility requirements, conditions, and exclusions in paragraphs _____ of the [PRODUCT NAME] agreement.		
12 CFR 37.6(d), "Form of Disclosures"		
Disclosures must be readily understandable Disclosures must be conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided.		
Disclosures must be meaningful Disclosures must be presented in a manner that engages the customer's attention. Examples of methods that could call attention to the nature and significance of the information provided include • plain-language headings. • typefaces and type sizes that are easy to read. • wide margins and ample line spacing. • boldface or italics for keywords. • distinctive type styles or graphic devices, such as shading or sidebars, when the disclosures are combined with other information.		

Appendix E: Debt Suspension and Debt Cancellation Product Information Questionnaire and Worksheet

Please answer the following questions for debt waiver programs overall and complete the attached worksheet for each debt suspension and debt cancellation product offered. Indicate whether responses are based on discussions with management or on an examination that included process review and verification.

For All Debt Suspension/Cancellation Products

1. Must the account be current to activate benefits? If not, are there delinquency limits with respect to benefit activation?

2. If accounts are delinquent when benefits are approved, does the bank re-age the account to current, freeze it at the payment/delinquency status at the time the benefit event occurred, or freeze it at the delinquency status at the time of claim approval?

3. At what delinquency status does the bank terminate coverage (e.g., cancel coverage or premium assessment at 90 days past due)?

4. Does the bank satisfactorily track and analyze the subsequent performance of the following populations for at least 12 months?

   - Accounts denied claims.
   - Accounts that failed to complete claims.
   - Accounts following benefit expiration.

5. If the default experience of the bank's retail loans is significantly worse than that of the population as a whole, is this information incorporated into the ALLL analysis?

6. How does the bank compute the interest and fees associated with accounts in claims status? Specifically, because interest and fees for revolving accounts are generally suspended, how does the bank determine the associated interest and fees that would have been due on a month-to-month basis?

7. What is the bank's process for reserving for benefit claims? Is it sufficient to cover the total of existing approved claims, claims in process and reasonably expected to be approved, and an estimate of claims not yet submitted by accounts in which an event has occurred?

8. If participating loans are securitized and the bank is responsible for making payments to the trust, are the trust reimbursements accurate and made monthly?

9. Is the bank's MIS sufficient to generate the information needed to establish and maintain an adequate reserve?

10. Is the bank's MIS sufficient to monitor and manage the various debt suspension and cancellation products?

11. Is the bank's pricing based on a valid cost analysis (considering all associated costs)?

12. Does the bank periodically evaluate cost/benefit from the customer's perspective? Is that analysis reasonable and reflected in the pricing?

13. Is flat rate pricing, if any, appropriate for low dollar loan amounts? Please explain.

14. How many written customer complaints has the bank received regarding these products year-to-date and in the prior full year?

15. Is the bank planning to offer additional debt suspension or cancellation products or significant product (coverage, pricing, etc.) or marketing (channel, emphasis) changes? If so, describe.

16. Examiners may want to listen to a sample of customer service representative call recordings to identify concerns with telemarketers or customer service representatives discouraging a customer from making a formal complaint to avoid a "denial" by the firm (potential unfair or deceptive acts or practices).

Debt Suspension/Cancellation Products Worksheet

Product name:
Offered since:
Retail credit product(s) covered:
Provider (bank, affiliate, third party):
Administrator (bank, affiliate, third party):
Responsible bank officer:

Benefit	Unemployment	Disability	Leave of absence	Death
Coverage: Specify maximum number of months, not available if not included, or yes/no for death				
Cost (e.g., statement balance x .0069)				
Individual				
Joint				
Benefit				
Interest and fees				
Principal				
Limits, if any (e.g., limited to number of months premiums paid before event)				
Is there a two-step process requiring added information for full benefit? (billing without full and clear disclosure of the process could result in an unfair or deceptive act or practice)				
Offered to self-employed customers?				
Penetration: Number of accounts paying premiums Percentage of portfolio				
Claims rate* (number of claims submitted/ number of accounts paying premiums), YTD and prior year				
Approval rate (number of claims approved/number of claims initiated), YTD and prior year				
Denial rate (number of claims denied/number of claims initiated), YTD and prior year				
Fallout rate (number of incomplete claims/number of claims initiated), YTD and prior year				
Bank income generated from premiums: YTD amount (percent) of total business line revenue of total business line pretax net income Prior year (percent) of total business line revenue of total business line pretax net income				
Cancellation policy, including refund policy				
Cancellation rate (number of cancellations/ number of accounts paying premiums pre-cancellation), YTD and prior year				
Attach a copy of the product terms and conditions				

***** Approval, denial, and fallout rates should balance to claims rate.

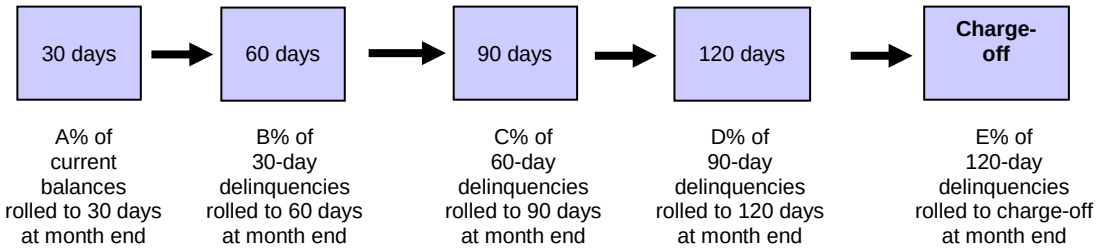
Appendix F: Loss Forecasting Tools

Reliable forecasts of expected customer charge-offs are critical for risk management, profitability, reserving, and capitalization. This supplement describes the three most common forecasting techniques: roll-rate, historical, and vintage analyses. Some banks use combinations of all three methods for different customer portfolios or forecasting purposes.

Roll-Rates

Roll and flow models comprise the most accurate short-term forecast technique. The name is derived from the practice of measuring the percentage of delinquent loans that migrate—"roll"—from early delinquency to late-stage delinquency buckets, or "flow" to charge-off. The most common method is the delinquency roll-rate model, in which dollars outstanding are stratified by delinquency status, typically current, 30-59 days past due, 60-89 days past due, and so on through charge-off. The rates at which loans roll through delinquency levels are then used to project losses for the current portfolio. The table below describes the mechanics of using roll-rate analysis to track the migration of balances over four months (120-day charge-off period).

Figure 2: Roll-Rate Schematic



Step 1: Calculate Roll-Rates

Step 1 is to calculate the roll-rates.[62] The computation begins with the hypothetical $725 million in loans that were current in June 2014. From June 2014 to July 2014, $27 million in loans rolled from current to 30 days delinquent, a roll-rate of 3.73 percent ($27 ÷ $725). From July 2014 to August 2014, $10.6 million rolled to the next delinquency bucket, representing a 39.26 percent roll-rate ($10.6 ÷ $27). Continuing along the diagonal (shaded boxes), loss rates increase in the latter stages of delinquency. To smooth out some fluctuations in the data, management often averages roll-rates by quarter before making current portfolio forecasts, and also compares quarterly roll-rate results between quarters to analyze and adjust for seasonal effects.

[62] The schematic and example above are simplified depictions of dollar flow to illustrate the basic concept of roll-rates. In reality, some balances cure (return to current), remain in the same delinquency bucket, or improve to a less severe delinquency status by the end of a period. For ease of calculation, roll-rate analysis assumes all dollars at the end of a period flow from the prior period bucket.

Table 1: Roll-Rate Calculation

Month	Current balance	30 days	Roll-rate	60 days	Roll-rate	90 days	Roll-rate	120 days	Roll-rate
June 2014	$724.7	$26.1		$9.9		$6.7		$3.6	
July 2014	$762.0	$27.0	3.73%	$10.9	41.77%	$7.1	71.27%	$4.7	70.36%
Aug. 2014	$788.6	$25.5	3.34%	$10.6	39.26%	$7.0	64.29%	$4.7	67.56%
Sept. 2014	827.7	$29.4	3.73%	$12.1	47.82%	$7.9	74.88%	$5.5	78.74%
3Q average			**3.60%**		**42.95%**		**70.15%**		**72.22%**
Oct. 2014	$844.6	$31.1	3.76%	$12.8	43.53%	$8.5	70.53%	$5.9	75.58%
Nov. 2014	$896.3	$26.7	3.16%	$12.4	40.03%	$8.2	64.52%	$5.9	69.49%
Dec. 2014	$987.3	$30.0	3.35%	$11.8	44.18%	$8.2	66.31%	$5.8	71.29%
4Q average			**3.42%**		**42.58%**		**67.12%**		**72.12%**
Loss factors			.70%		20.61%		48.41%		72.12%

Step 2: Calculate Loss Factors by Bucket

Step 2 is to calculate loss factors for each bucket. To calculate the loss factor from the "current" bucket, multiply all of the average roll-rates from the most recent quarterly average. In this example, the fourth-quarter average roll-rates produce this factor: 3.42% x 42.58% x 67.12% x 72.12%, resulting in a 0.70 percent loss rate for loans in the current bucket. To determine the loss rate for the 30-day accounts, multiply the most recent quarterly averages for the 60-, 90-, and 120-day buckets, resulting in a loss factor of 20.61 percent. Applying the same method results in a loss factor of 48.41 percent for the 60-day bucket, and 72.12 percent for the 90-day bucket.

Step 3: Apply Loss Factors to Current Portfolio

Step 3 is to forecast losses for the existing portfolio by applying the loss factors for each bucket (developed in step 2) to the current portfolio. In this example the portfolio's expected loss rate over the next four months is 2.93 percent.

Table 2: Forecasting Loss Rate

Dec. 31, 2014	Outstandings	Loss factor	Loss forecast
Current	$987.4	0.70%	$6.9
30 days	30.2	20.61%	6.2
60 days	11.8	48.41%	5.7
90 days	8.2	72.12%	5.9
120 days	5.9	100%	5.9
Totals	**1,043.5**	**2.93**	**30.6**

The major advantage of roll-rate analysis is its relative simplicity and considerable accuracy out to nine months. Portfolios are often segmented by product, customer type, or other relevant groupings to increase precision and accuracy. Roll-rate reports are used extensively by collection managers to anticipate workload and staffing needs and to assess and adjust collection strategies.

The main limitation of roll-rate analysis is that the predictive power of delinquency roll-rate analysis declines after nine months because the delinquency focus causes forecasts to lag underlying changes in portfolio quality, especially in the relatively large current bucket. Portfolio quality changes occur because of factors such as underwriting and cutoff score adjustments, product mix changes, and shifts in economic conditions. Roll-rate analysis may underestimate loss exposure when these factors cause portfolio quality to weaken. Finally, roll-rate methodology assumes loans migrate through an orderly succession of delinquency stages before charge-off. In actuality, customers often migrate to charge-off status after sporadic payments or rush to that status by declaring bankruptcy.

Historical

Historical averaging is a rudimentary method for forecasting loss rates. Management tracks historical charge-offs, adjusts for recent loss experience trends, and adds some qualitative recognition of current economic conditions or changes in portfolio mix. This method is highly judgmental and is used primarily by less sophisticated banks or for stable, conservatively underwritten products. The most common of these products are residential mortgages when the collateral protection is conservative or the loans carry some sort of third-party guarantee or insurance.

This method is sometimes used for ALLL purposes and monitoring general product or portfolio trends. The advantage is simplicity, and data needs are modest. Results can be reasonably accurate so long as underwriting standards remain relatively constant and economic or competitive conditions do not change markedly. The major limitation is that forecasts will lag underlying changes in portfolio quality if competitive or economic conditions change. The judgmental nature of the process also introduces potential bias by allowing forecasters to rely on longer-run averages when conditions deteriorate and short-run trends at the earliest signs of recovery, either of which results in lower loss estimates. In addition, the method does not provide meaningful information on the effects of changes in product or customer mix, and it is difficult to apply any but the most basic stress tests.

Vintage

Vintage-based forecasting tracks delinquency and loss curves by time on books as different vintages or marketing campaigns. The patterns or curves are predictive for future vintages, provided adjustments are made for changes in underwriting criteria, altered cutoffs, and economic conditions. The advantage of vintage-based forecasting is that its accuracy is usually better than roll-rate forecasts for charge-offs beyond a one-year horizon, provided that the need for adjustments is readily observed. Management should adjust the future loss expectations when new vintages are observed to deviate markedly from past curves and

trajectories, or if economic and market conditions change. The disadvantages of a vintage-based forecast are that it is more subjective and less accurate than roll-rates for short-term forecasting and that it relies on the assumption that new vintages will perform similarly to older vintages.

Appendix G: Credit Scoring and Development of Scoring Models

There are several statistical methods used to construct credit scoring models (e.g., multiple linear regression, logit and probit, discriminant analysis, and general linear models). Each method has advantages; in practice, however, all of these methods generally produce a similar prediction of the relative credit quality of borrowers by capturing the underlying correlation between the borrowers' risk characteristics and delinquency behavior. These models use those factors correlating most strongly with good or bad performance.

Scoring models used for underwriting should include data from rejected applications to correct for estimation bias that arises if only approved accounts are used. If rejected applicants are systematically excluded from a model's development, sample correlation between the applicants' characteristics and delinquency reflect only the behavior of the relatively good segment of the population. When the model is applied to the general population, it overestimates the relative quality of the accounts with characteristics similar to those that were rejected, increasing the likelihood that lower-quality applicants are approved.

Scoring models are only as good as the data used to develop the models. These models predict the behavior of new applicants based on the performance of previous applicants. If the distribution of characteristics in the through-the-door population shifts (for example, because of a change in marketing strategy that successfully attracts applicants from outside the bank's current market), the model's ability to discriminate between "good' and "bad" accounts may deteriorate. Other elements affecting a model's ability to rank order risk arise from using different sources to select sample applicants, using data from new market areas, and changing credit policy. Economic or regulatory changes also can affect a model's reliability. For those reasons, a bank should continue to validate that the current population of applicants is similar to the population used to develop the model.

Models are rescored before system implementation to validate their ability to rank order risk as designed. The validation process should ensure that the demographic profiles of current applicants or the names selected for prescreening are similar to those used in the sample. The process also measures the divergence in performance between two populations (e.g., through-the-door applications compared with the development sample used to build the model) and sets credit scoring norms to account for slight shifts in the population credit score. The chi-square goodness-of-fit measure test, the Kolmogorov-Smirnov measure of divergence test, and the Population Stability Index are the most common statistical validation tests banks use to assess the accuracy, reliability and discriminatory power, and stability of a model, respectively. Validations tests are common and used to ensure that model results are accurate and effective in maintaining strong risk management processes.

Scoring models generally become less predictive over time because they are typically developed without explicitly capturing the time-sensitive impact of changing economic and market conditions. Applicant characteristics, such as income, job stability, and age, change, as do overall demographics. These changes result in significant shifts in the profile of the through-the-door applicants. Once a fundamental change in the profile occurs, the model is

less able to identify potentially good and bad applicants. As these changes continue, the model loses its ability to rank order risk. Thus, credit scoring models should be redeveloped as necessary.

After a scoring system is implemented, the developer provides bank management with a manual that details system maintenance requirements and recommended methods for supervising the system. Bank management should adhere closely to the manual's specifications, particularly those that provide guidance for periodically assessing the performance of the system. This often includes comparing actual results with system objectives.

For systems developed by outside vendors, examiners should review vendor guidelines in conjunction with bank management's procedures for periodically assessing the system and the frequency of such assessments. One quick way to evaluate a system's general performance is to determine whether a direct correlation exists between credit scores and delinquency rates (that is, delinquency rates increase as risk increases). Another way is to review the management reports described in this appendix.

Types of Scoring Systems

Application Scoring

Systems that rely on data from credit applications augmented by credit bureau data are the most common types of credit scoring systems. Key items of application information (and credit bureau information, when available) are assigned point values. Typical application data include continued employment over a period of time, length of credit history, and rent or mortgage payments over a period of time. Banking references, credit references, reported delinquencies, recent credit bureau inquiries, and recently opened accounts are assigned point values that reflect a customer's use of credit. The total of these point values (final score) reflects the relative likelihood that the customer will repay as contracted.

Credit Bureau Risk Scoring

An application is sent to one of the credit bureaus for scoring based on the contents of the application and the payment history in the applicant's credit bureau report. The system statistically ranks current elements of a credit report to predict the customer's future payment behavior.

Banks purchase credit bureau scores for use in applicant screening, account acquisition, and account management strategies.

- **Applicant screening:** For approving or declining the loan, establishing initial credit limits, and setting up a tiered pricing of loans.
- **Account acquisition:** Used in solicitation programs, in cross-selling opportunities of other products, and for acquiring portfolios from other banks.

- **Account management:** For determining increases and decreases of credit limits and establishing authorizations, reissue, and collection parameters.

Credit bureau scores are designed to predict the relative credit quality of a borrower based on a common set of credit bureau characteristics. A good account is one with no delinquencies or an isolated delinquency. A bad account exhibits seriously delinquent behavior or worse (i.e., bankruptcy, charge-off, or repossession).

More than 100 predictive variables are evaluated during the development or redevelopment cycle. Such variables include previous credit performance, current level of indebtedness, amount of time credit has been in use, pursuit of new credit, and types of credit available. Bank management should revalidate bureau scorecards as warranted. An integral part of the revalidation process involves assessing the variables and comparing the model's actual performance to its expected performance.

Scorecard vendors have risk scorecards at the major credit bureaus. The vendor uses the same process at each bureau to update and validate the scorecards. Generally, vendors evaluate the individual's performance at the time of revalidation and 24 months before revalidation. The earlier of these reports is used to generate the predictive information, and the later one is used to determine the performance of that account in the two years since the observation of the predictive information.

Credit Bureau Bankruptcy Scoring

Bankruptcy scorecards are used primarily to predict the likelihood that a customer will declare bankruptcy or become a collection problem. Credit bureaus derive their bankruptcy scorecards from information in a customer's credit file containing credit histories from all reporting sources. Several bankruptcy scorecards are usually available at each credit bureau.

Behavioral or Performance Scoring

Behavioral scoring is a technique used to segment a portfolio of existing accounts based on the past behavior of the borrowers. Banks use behavioral scores for collection strategies, authorization requirements, credit line assignments, and renewal decisions. This scorecard predicts which accounts will become delinquent within the next six to 12 months. Behavioral scoring relies principally on credit line use patterns (revolving credit) and payment patterns. Behavioral scoring models consider elements such as payment history, the number of times the payment has been greater than the minimum required, delinquency history, and use of the cash advance option. Credit bureau input may also be used.

Emerging neural net technology has enhanced the effectiveness of behavioral modeling. Neural nets are computer programs that can sort through huge amounts of data and spot patterns in a way that mimics human logic. This knowledge is then factored into subsequent decisions.

Collection Scoring

Scoring models that focus on collection activities include the following:

- **Collection scoring:** These systems show the likelihood that collection efforts will succeed. They help a bank allocate collection resources efficiently.
- **Payment projection scoring:** These systems identify the likelihood that a bank will receive a payment on a delinquent account within six months. The collection department can use this information to determine on which accounts it needs to focus.
- **Recovery scoring:** These systems identify the likelihood of recoveries after charge-off. The collection department can use these systems to minimize charge-off losses.

Adaptive Control

Banks can use behavioral scoring to examine alternative credit strategies. These strategies employ a technique called "adaptive control." Adaptive control systems include software that allows bank management to develop and analyze various strategies that take into account the customer population and the economic environment. Adaptive control systems are credit portfolio management systems designed to reduce credit losses and increase promotional opportunities. New strategies (called challenger strategies) can be tested on a portion of the accounts while retaining the existing strategy (called the champion strategy). When a challenger strategy proves more effective than the existing champion, the bank replaces the champion strategy with the challenger. Continual testing of alternative strategies can help the bank achieve better profits and control losses in five areas:

- **Delinquent collections:** All accounts are checked for delinquency at billing time. Delinquent accounts are evaluated and actions are assigned to be taken throughout the next month. For example, computer-generated notices can be sent to account holders at varying intervals for 30 days; if the account remains delinquent, collectors can make phone calls every five days. Delinquent accounts are then reexamined for a change in account status. If there is no change, assigned actions proceed. If an account is no longer delinquent, actions are stopped. Accounts also can be reevaluated and assigned different actions (called dynamic reclassification).
- **Authorizations:** Accounts are examined at billing and assigned an authorization strategy to be used by the authorization system throughout the month. The authorization system requests a decision on accounts in early delinquency.

Strategies for Selecting and Changing Cutoff Score

Three strategies may be used separately or together to select the cutoff score. The first strategy targets an approval or acquisition rate. The cutoff is set to result in a specified number of new accounts. Used separately, this may be the least desirable approach because it does not capture any projected performance of the accounts. The second strategy targets a credit loss rate. A cutoff score is selected that sets an acceptable level of losses. The third

strategy targets the product's profitability. A cutoff score can optimize expected profitability in terms of total profit center earnings, return on risk assets, or return on total assets.

The following are some of the most common reasons for changing a credit cutoff score:

- To approve previously declined accounts that are now believed to be potentially profitable.
- To decline previously approved accounts that are now observed to be unprofitable.
- To reduce losses or improve collections.
- To respond to increased or reduced competition in the marketplace.
- To comply with external suasion (e.g., regulators or consumer groups) to ease or restrict credit availability.
- To compensate for aging or eroding scoring models.

Management Reports

- **Population stability report:** This report measures changes in applicant score distribution over time. The report compares the current application population with the population on which the scoring system was developed. This comparison is made using a formula called the Population Stability Index, which measures the separation of the two distributions of scores. (The scoring manual provided by the system developer should have instructions on how to interpret the variances.) For example, in a commonly used scorecard, a value under 0.100 indicates that the current population is similar to the original and no action is necessary. A value between 0.100 and 0.250 suggests that bank management should research the cause of the variance. A value over 0.250 suggests that substantial change has occurred in the population or in underwriting policies.
- **Characteristic analysis report:** This report measures changes in applicants' scores on individual characteristics over time. It is needed when the applicant population stability has changed and the bank wants to determine which characteristics are being affected. The report compares individual characteristics of the current applicants with those of the original population used in developing the scoring model. For example, checking and savings account references may be a better predictor of future behavior when the applicant has more history with the bank. This report can be used to identify the primary reasons for any shift in the applicant population from the development sample. Bank management should generate a report for each characteristic and review them individually and as a total.
- **Final score report:** This report measures the approval rate and adherence to the scorecard. It shows the number of applicants at each score level and the number of applications accepted and rejected. The report also can be used to analyze the effect of factors outside the scorecard.
- **DDR:** This report monitors portfolio quality by score ranges. Two types of reports may be used. One measures how well a scorecard is working, and the other measures current portfolio quality and changes in portfolio quality. The report compares accounts of different ages at equal stages in their account lives and reveals changes in the portfolio's behavior. Bank management should identify the causes for those changes. A vintage

analysis table, which identifies accounts by year of origin, is used to compare a series of DDRs and can be used to identify portfolio trends.

- **Portfolio chronology log:** This log is an ongoing record of significant internal or external changes or events that could affect the performance of the accounts. The log helps explain causes of behavior in various tracking reports. Some examples of events that should be recorded are new marketing programs, application form changes, new override policies, new collection strategies, changes in the debt-to-income ratio, or changes in income requirements.
- **Lender's override report:** This type of report identifies the volume of high-side and low-side overrides by month and year-to-date, provides a comparison over time and against the bank's benchmark, and may include reasons for the overrides. Examiners should evaluate the trends in model accuracy and stability for signs of model deterioration that may adversely affect the effectiveness of the strategies that rely on the models as inputs.

Income Estimators

The use of income estimator (IE) models, as with any type of model, invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision making, or damage to a bank's reputation. Banks that use IE models should have effective model risk management programs consistent with supervisory guidance contained in OCC Bulletin 2011-12.

The ability of existing IE models to accurately estimate the income of a specific borrower may be limited and as a result may pose safety and soundness concerns. In some cases, to compensate for the inherent inaccuracy of the models, banks have asked if they can apply conservatism or use a confidence score threshold, e.g., if the IE model estimates a customer's income to be $150,000, then the bank is 90 percent confident the borrower makes more than $75,000. In this example, the bank would underwrite and grant a credit line increase commensurate with a lower borrower income. Conservatism may impede proper model development and application, lead model users to discount model outputs, and potentially introduce unintended bias to underwriting decisions. Confidence scores may have limited effectiveness for safety and soundness purposes.

Even with skilled modeling and robust validation, IE model risk cannot be eliminated, so other tools, including monitoring of model performance, adjusting or revising the models over time, and establishing limits on model use, should be used to manage model risk. Active management of model risk, in accordance with the OCC's supervisory guidance, can minimize potential safety and soundness concerns.

Appendix H: Glossary

Adaptive control system: Adaptive control systems are credit portfolio management systems designed to reduce credit losses and increase promotional opportunities. Adaptive control systems include software that allows management to develop and analyze various strategies that take into account customer behavior and the economic environment. See **champion/challenger strategy**.

Add-on: An additional service or credit product sold in connection with a credit account. Examples include travel clubs, disability insurance, credit life insurance, debt suspension insurance, debt cancellation insurance, and fraud alert programs.

Advance rate: In financing customer purchases, the amount that a bank advances in the form of a loan in relation to the value of the underlying collateral. For example, for new automobiles, the advance rate may be calculated based on the vehicle invoice or MSRP.

Adverse selection: A disproportionately high response or acceptance rate to a marketing offer by high-risk customers in the targeted population. This situation generally occurs because the product or promotional design is flawed.

Allowance for loan and lease losses (ALLL): A valuation reserve that is an estimate of uncollectible amounts (inherent losses) and is used to reduce the book value of loans and leases to the amount that is expected to be collected. The ALLL is established and maintained by charges against the bank's operating income, i.e., the provision expense.

Application scoring: The use of a statistical model to objectively score credit applications and predict likely performance.

Attrition: The closing of accounts. All retail credit loan products undergo attrition, but the term is most commonly applied to credit card accounts.

Broker: An individual or company that sources customers for loans and then places those loans with banks for funding.

Buy rate: The interest rate the bank charges for loans purchased through third-party dealers. Used in indirect lending.

Captive finance company: The financing arm of an automobile manufacturer, such as Ford Motor Credit Company.

Cash collateral account: A credit enhancement common in asset-backed security structures. The cash collateral account is held in a segregated trust account, funded at the outset of the deal, and can be drawn on to cover shortfalls in interest, principal, or servicing expense for a particular series if the excess spread is reduced to zero.

Champion/challenger strategy: A process to determine the most effective way of managing existing accounts. Usually driven by behavioral scores, the "champion" strategy is applied to the majority of the accounts, while various "challenger" strategies are applied to smaller portions of the portfolio. The results of the challenger strategies are compared against those of the champion to determine whether to install a new champion. Champion/challenger strategies are used extensively in the collection area for all types of retail loans and for ongoing account management functions for closed-end credit.

Chattel: an item of property other than real estate.

Chronology log: A chronological record of internal and external events relevant to the credit function.

Closed-end: A loan or extension of credit in which the proceeds are disbursed in full when the loan closes and must be repaid, including any interest and finance charges, by a specified date.

Coincident: Refers to end-of-period delinquencies and losses in relation to total as of the same date. Distinguished from vintage, lagged, and other time series measures.

Consumer credit counseling (CCC): Service offered by nonprofit agencies that counsel overextended consumers and funded by bank "fair share" contributions (a negotiated percentage of the consumer's payment to the bank). CCC entities work with consumers and their banks to develop a budget and a debt repayment plan. Banks generally offer concessions to customers in CCC programs.

Consumer reporting agency: Any entity that, for monetary fees, dues, or on a cooperative nonprofit basis, regularly engages in whole or in part in the practice of assembling or evaluating consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties, and that uses any means or facility of interstate commerce for the purpose of preparing or furnishing consumer reports.

Credit bureau: A consumer reporting agency that is a clearinghouse for information on the credit ratings of individuals or businesses. The three largest credit bureaus in the United States are Equifax, Experian, and TransUnion.

Credit report: Report from a consumer reporting agency providing a consumer's credit history. Credit reports are convenient and inexpensive for banks to obtain because larger users typically pay lower rates than smaller users. Mortgage lenders usually require more thorough and detailed credit reports than lenders making smaller retail loans. A merged credit report contains files from the three major credit bureaus.

Credit scoring: A statistical method for predicting the creditworthiness of applicants and existing customers.

Cross-selling: The use of one product or service as a base for selling additional products and services.

Dealer: The retail outlet for automobile or manufactured housing sales. Dealers take loan applications from their customers and "shop" them to banks for approval and funding.

Dealer reserve: Bank-controlled, dealer-specific deposit accounts used to accumulate the difference, when applicable, between the interest rate paid by borrowers on indirect installment loans and the rate at which the bank purchased the contracts from the dealers (see **buy rate**). Collected funds are released to the dealers according to the terms of the dealer agreements.

Debt burden ratio: Measure of the customer's ability to repay a debt. One common measure includes the debt-to-income or debt service ratio, which measures monthly debt obligations against monthly income.

Debt cancellation contract: A loan term or contractual arrangement modifying loan terms under which a bank agrees to cancel all or part of a customer's obligation to repay an extension of credit from that bank upon the occurrence of a specified event.

Debt service: A measure of a customer's income in relation to committed debt payments.

Debt suspension agreement: A loan term or contractual arrangement modifying loan terms under which a bank agrees to suspend all or part of a customer's obligation to repay an extension of credit from that bank upon the occurrence of a specified event.

Deferral: Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, of the loan.

Extension: Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown as current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan.

Five Cs of credit: Term used to describe the evaluation criteria typically used in a judgmental credit decision: character, capacity, capital, collateral, and conditions.

Fixed payment programs (cure programs): Also described as workout programs, these include CCC and in-bank programs designed to help customers work through some type of temporary or permanent financial impairment. Cure programs typically involve a reduced payment for a specified period of time and may also include interest rate concessions.

High-side override: A denied loan that meets or exceeds the established credit score cutoff. To compute a bank's high-side override rate, divide the number of declines scoring at or above the cutoff score by the total number of applicants scoring at or above the cutoff.

Inherent losses: The amount of loss that meets the conditions of ASC 450 for accrual of a loss contingency (i.e., a provision to the ALLL).

Lagged analysis: Analysis that minimizes the effects of growth. Lagged analysis uses the current balance of the item of interest as the numerator (e.g., loans past due 30 days or more), and the outstanding balance of the portfolio being measured for some earlier time period as the denominator (generally six or 12 months before).

Low-side override: An approved loan that fails to meet the scoring criteria. To compute the low-side override rate, divide the number of approvals scoring below the cutoff score by the total number of applicants scoring below the cutoff.

Loss mitigation: Loan collection techniques used to reduce or eliminate the possible loss.

Managed assets: Total balance sheet assets plus all off-book securitized assets.

Negative amortization: An increase in the capitalized loan balance that occurs when the loan payment is insufficient to cover the interest and fees due and payable for the payment period.

Open-end: consumer credit extended by a creditor under a plan in which: (i) the creditor reasonably contemplates repeated transactions; (ii) the creditor may impose a finance charge from time to time on an outstanding unpaid balance; and (iii) the amount of credit that may be extended to the consumer during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid.

Pay-ahead: Keeping track of excess payment amounts and reducing the next consecutive payment(s) accordingly. As a result, the customer is not required by the bank to make payments until the amount of the overage has been extinguished. For example, if a customer's automobile payment is $200 per month and the customer remits $600, the next payment will not be due until the third subsequent month. Pay-aheads can pose increased risk, as they do not require a minimum payment every month. When banks require customers to make monthly payments, it enables the banks to monitor portfolio quality through more accurate delinquency reporting. Banks should limit the use of pay-aheads to accounts with low risk characteristics.

Payment holidays (skip-a-pay): Programs giving the bank's most creditworthy customers the option of foregoing or skipping payments for a given month. Interest continues to accrue for the skipped time period. These programs are sometimes offered as frequently as twice a year, and usually coincide with summer vacations, late-summer back-to-school shopping, or December holidays.

Penalty pricing: Increased loan or line finance charge imposed when a borrower fails to pay as agreed, based on performance criteria in the loan or cardholder agreement.

Point of sale: Where a customer engages in a retail transaction.

Prepayment: The closing of accounts; also used to describe attrition in closed-end retail credit products.

Prescreen (preapprove): To score or otherwise qualify a list of names or defined credit bureau population using credit bureau information with the intent of making a firm offer of credit to those meeting the criteria.

Price points: The price tiers into which banks segment retail portfolios. Price points show rates and outstandings in each tier. Especially important when teaser rates are offered, price points enable banks to model past, present, and future revenue and the impact of shifts that result from pricing strategies. Some banks identify three tiers, such as low-rate teasers, medium-rate standard products, and high-yield loans.

Promise to pay: A term used in collection departments to describe customers who have been contacted regarding their delinquent accounts and have committed to remitting a payment. Once the payment is received, it would be reported under "promises kept."

Renewal: Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms.

Repossession: Seizure of collateral securing a loan in default.

Residual value: Anticipated or fair market value of an asset at the expiration of a lease.

Rewrite: Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or final maturity.

Right-party contacts: Communicating directly with the borrower or someone who is legally designated to make decisions for the borrower, such as a person with a power of attorney.

Roll-rate: Roll-rates measure the movement of accounts and balances from one payment status to another (e.g., percentage of accounts or dollars that were current last month rolling to 30 days past due this month).

Securitization: The process of creating an investment security backed by credit card receivables, installment loans, or other loans.

Stress testing: Analysis that estimates the effect of economic changes or other changes on key performance measures (e.g., losses, delinquencies, and profitability). Key variables used in stress testing could include interest rates, score distributions, asset values, growth rates, and unemployment rates.

Subprime lending: Extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.

Third-party vendor: Any third party that performs a function or provides a service on the bank's behalf. Although generally associated with outsourcing, equipment and supply providers are also considered third-party vendors.

Vintage analysis: Grouping loans by origination time period (e.g., quarter) for analysis purposes. Performance trends are tracked for each vintage and compared to other vintages for similar time on book.

Appendix I: Abbreviations

ALG	Automotive Lease Guide
ALLL	allowance for loan and lease losses
ASC	Accounting Standards Codification
BAAS	Bank Accounting Advisory Series
CCC	consumer credit counseling
CFPB	Consumer Financial Protection Bureau
CFR	Code of Federal Regulations
DCC	debt cancellation contract
DDR	delinquency distributions report
DSA	debt suspension agreement
EIC	examiner-in-charge
FAQ	frequently asked questions
FFIEC	Federal Financial Institutions Examination Council
FINDRS	Financial Institution Data Retrieval System
Fed. Reg.	*Federal Register*
FSA	federal savings association
GAAP	generally accepted accounting principles
HOLA	Home Owners' Loan Act
HUD	U.S. Department of Housing and Urban Development
ICQ	internal control questionnaire
IE	Income Estimator
IT	information technology
LPM	Loan portfolio management
LTV	loan-to-value
MDDR	maximum delinquency distributions report
MIS	management information systems
NCT2	National Credit Tool 2
NSF	not sufficient funds
OCC	Office of the Comptroller of the Currency
OCL	over-credit-limit
QA/QC	quality assurance/quality control
RCCP	Retail Credit Classification and Account Management Policy
TDR	troubled debt restructuring
UDAP	Unfair or deceptive acts or practices
USC	U.S. Code
YTD	year to date

References

Federal Consumer Protection Laws and Implementing Regulations

10 USC 987 and 32 CFR 232, "Military Lending Act"
12 USC 2601 and 12 CFR 1024 (Regulation X), "Real Estate Settlement Procedures Act"
15 USC 45, "Federal Trade Commission Act"
15 USC 1601 et seq. and 12 CFR 1026 (Regulation Z), "Truth in Lending Act"
15 USC 1639, "Home Ownership and Equity Protection Act"
15 USC 1681 et seq., "Fair Credit Reporting Act," as amended by the Fair and Accurate Credit Transactions Act of 2003; 12 CFR 1022, "Fair Credit Reporting (Regulation V)"
15 USC 1691 et seq. and 12 CFR 1002 (Regulation B), "Equal Credit Opportunity Act"
15 USC 1692 et seq., "Fair Debt Collection Practices Act"
15 USC 6801 et seq., and 12 CFR 1016, "Gramm–Leach–Bliley Act"
15 USC 7001 et seq., "Electronic Signatures in Global and National Commerce Act"
42 USC 3601 et seq., "Fair Housing Act"; 24 CFR 100.1 et seq., "Discriminatory Conduct Under the Fair Housing Act"
50 USC, appendix 501, et seq., "Servicemembers Civil Relief Act"

Other Laws and Regulations Applicable to Installment Lending

Statutes

National Banks
12 CFR 3 subpart C (12 CFR 3.20–3.22), "Components of Capital"
12 CFR 3 subpart D (12 CFR 3.30–3.63) and subpart E (12 CFR 3.100–3.173), "Risk-Based Capital Credit Risk-Weight Categories"
12 USC 24, "Corporate Powers of Associations"
12 USC 484, "Limitation on Visitorial Powers"

Federal Savings Associations
12 USC 1464, "Federal Savings Associations"

Regulations

12 CFR 3 subpart C (12 CFR 3.20–3.22), "Definition of Capital"
12 CFR 3 subpart D (12 CFR 3.30–3.63) "Risk-Weighted Assets-Standardized Approach" and E (12 CFR 3.100–3.173), "Risk-Weighted Assets – Internal Ratings-Based and Advanced Measurement Approaches"
12 CFR 21.21, "Procedures for Monitoring Bank Secrecy Act Compliance"
12 CFR 30, "Safety and Soundness Standards"
12 CFR 41, subparts I and J, "Proper Disposal of Records Containing Consumer Information" and "Identity Theft Red Flags"

National Banks
12 CFR 7.4000 "Visitorial Powers"
12 CFR 7.4001 "Charging Interest By National Banks At Rates Permitted Competing Institutions"
12 CFR 7.4002 "National Bank Charges"
12 CFR 7.4008 "Lending"
12 CFR 21.11, "Suspicious Activity Reports"
12 CFR 23, "Leasing"
12 CFR 37, "Debt Cancellation Contracts and Debt Suspension Agreements"

Federal Savings Associations
12 CFR 7.4010 "Applicability of State Law and Visitorial Powers to Federal Savings Associations and Subsidiaries"
12 CFR 128, "Nondiscrimination Requirements"
12 CFR 160, "Lending and Investment"
12 CFR 162, "Regulatory Reporting Standards"
12 CFR 163.176, "Interest Rate Risk Management Procedures"
12 CFR 163.180, "Suspicious Activity Reports and Other Reports and Statements"

Other Agencies

Statutes
12 USC 1818, "Termination of Status as Insured Depository Institution"
31 USC 5312(a)(2), "Bank Secrecy Act"

Regulations
17 CFR 229.1100, "Asset-Backed Securities" (Regulation AB)
12 CFR 330.7(d), "Accounts Held by Agent, Nominee, Guardian, Custodian, or Conservator"

Comptroller's Handbook

Consumer Compliance
"Fair Credit Reporting"
"Fair Lending"
"Other Consumer Protection Laws and Regulations"
"Privacy of Consumer Financial Information"
"Real Estate Settlement Procedures Act"
"SAFE Act"
"Servicemembers Civil Relief Act"
"Truth in Lending Act"

Examination Process
"Bank Supervision Process"
"Community Bank Supervision"
"Federal Branches and Agencies Supervision"

"Large Bank Supervision"
"Sampling Methodologies"

Safety and Soundness, Asset Quality
"Allowance for Loan and Lease Losses"
"Concentrations of Credit"
"Loan Portfolio Management" (not applicable to FSAs)
"Rating Credit Risk"
"Retail Lending Examination Procedures" (not applicable to FSAs)

Safety and Soundness, Liquidity
"Liquidity"
"Asset Securitization"

Safety and Soundness, Management
"Internal and External Audits"
"Internal Control"

Office of Thrift Supervision Examination Handbook

Section 209, "Sampling" (November 2010)
Section 221, "Asset-Backed Securitization" (September 2003)
Section 340, "Internal Control" (October 2009)
Section 350, "External Audit" (July 2002)
Section 355, "Internal Audit" (February 2002)
Section 760, "New Activities and Services" (September 2009)
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OCC Issuances

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Advisory Letter 2000-11, "Title Loan Programs" (November 27, 2000) (national banks)
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Bulletin 2009-23, “Fair Credit Reporting: Accuracy and Integrity of Consumer Report Information and Direct Consumer Dispute Regulations and Guidelines” (July 20, 2009) (national banks)Bulletin 2010-25, “Property Assessed Clean Energy (PACE) Programs: Supervisory Guidance” (July 6, 2010)
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Other

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