

RESCINDED

Replaced: See OCC Bulletin 2015-41

Credit Card Lending

Credit cards are among the most widely used forms of consumer credit. All types of merchants, from department stores to gas stations and grocery stores, now accept credit cards. Generally, credit card products contain terms that include the ability of the lender to reprice individual accounts based on customer payment practices and other performance factors. This, along with the traditionally higher rates of return associated with credit card lending, has led to a significant increase in competition among credit card issuers, putting pressure on their profit margins. In response, issuers have sought to cut costs and increase revenues, possibly elevating their risk exposure.

LINKS

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The Home Owners' Loan Act (Section 1464(c)(1)(I)) (HOLA) authorizes federal savings associations to invest in credit cards and loans made through credit card accounts without a statutory percentage of asset limitation. While many lenders consider credit card accounts to individuals as consumer loans, HOLA's credit card lending authorization is separate from and in addition to the investment limits for other loans and investments authorized under HOLA. As a result, a federal savings association does not have to aggregate its consumer related credit cards with other consumer loans in determining its compliance with the 35 percent investment limit for consumer loans. Likewise, a federal savings association does not have to aggregate its business related credit card accounts with loans made under HOLA's commercial loan authority.

While there is no statutory percentage-of-assets limitation on credit card loans and investments, OTS may establish an individual limit on a savings association's credit card exposure should its concentration present a safety and soundness concern.

This handbook section focuses on credit card issuers. This role is the most comprehensive and presents the most risk. We divided the discussion of Credit Card Lending into three sections:

- Overview includes guidance on credit card risks and controls, the various product lines, and subprime lending.
- Credit Card Operations includes discussions of underwriting and account management and collection practices.
- Securitizations include discussions of trust structure, recourse and credit enhancements.

OVERVIEW

Credit Card Risks and Controls

Credit card accounts are often unsecured, open-ended extensions of credit and can present a significant amount of credit risk to the issuer. The issuer may manage these risks by extending accounts to those borrowers who have the willingness and ability to repay and setting reasonable account limits based on the risk profile of the account holder. Because of a high level of fixed overhead expenses associated with relatively small loan amounts and a high number of transactions per account, credit card issuers rely on issuing a large volume of cards to maintain profitable operations. One of the greatest challenges to credit card issuers is generating a sufficient volume of accounts to be profitable, while maintaining an acceptable level of credit risk by being selective in granting accounts and credit lines.

High-volume issuers typically use an automated process to approve new accounts. As a result, approval decisions are faster but rely on less verification than other types of lending. Information used to make a credit decision normally consists of credit bureau reports and data from the borrower's application. While it is important for the issuer to verify the information provided by the borrower, the level of verification should depend on the amount of credit extended to the borrower and the level of risk the financial institution is willing to accept and prudently capable of assuming. The larger the amount of credit the financial institution authorizes, the more care it must take in underwriting and verifying borrower information.

Competition among credit card issuers is intense, with the industry competing with other issuers of MasterCard, Visa, Discover Card, American Express, private label cards, and the growing market of smart cards and debit cards. Most prospective account holders receive many credit offers. This increased availability of credit increases the risk that some borrowers will become overextended, especially during periods of financial stress. In addition, increased competition often leads to more aggressive pricing and account management practices that increase the risk profile of the credit card portfolio. Therefore, constant monitoring of account performance and activity is essential for a sound credit card operation.

A prudent credit card program requires strong management and controls throughout the life of the account.

A prudent credit card program requires strong management and controls throughout the life of the account, including underwriting, acquisition, account management, and collections. Controls should include regular reviews of the credit card operation by management as well as periodic reviews by internal audit, and the credit risk, loan review, and compliance review functions. Given its importance to a credit card operation, management information systems (MIS) and controls should be strong.

Product Lines

Financial institutions offer many different types of credit card accounts. Broad product lines include general use cards, affinity cards, business cards, private label cards, and secured cards.

- General use credit cards – Issuers offering general use credit cards are usually members of Visa, MasterCard, Discover, or American Express. The issuer pays a fee to utilize the worldwide interchange systems, which provide interbank settlements of credit card transactions and point of sale authorization systems.
- Affinity or co-branded cards – Usually an issuer is in partnership with businesses, associations, and nonprofit groups that provide Visa or MasterCard credit. Issuers emboss the cards with the partner's logo, and the partner may offer cardholders some financial incentives, such as rebates or discounts. The partner receives a portion of the income generated by the accounts, usually part of the interchange fee. Use of the card may also generate additional business. An affinity program offers the issuer an additional marketing avenue to help increase receivable balances.
- Business or corporate cards – A company issues credit cards to its employees. A contract between the issuer and the company establishes credit lines, repayment terms, and whether or not the company guarantees the loans. The employee generally uses the card for business purposes such as travel and entertainment, but sometimes uses the card for general corporate expenses. Business credit cards carry the same level of risk as corporate loans and require the issuer to carefully underwrite the sponsoring corporation.
- Private label cards – Retailers, such as department stores or gas stations, may issue private label cards in partnership with a financial institution. Retailers generally issue private label cards for use only at their stores. Thus, private usage cards are more limited than general use credit cards.
- Secured cards – Secured cards are general use credit cards fully or partially secured by cash deposits. Issuers provide these cards to applicants with poor or limited credit histories who may not qualify for a regular credit card. While fees and charges are usually higher than regular credit cards, a secured card allows a cardholder to establish or reestablish a good credit standing. A secured card program generally involves lower line amounts and more transactions per account than a standard card program, which increases overhead expenses. Underwriting, monitoring of over-limit accounts, and strong collections practices are particularly important for this type of account. In addition, financial institutions should establish a security interest in the collateral deposit and monitor the deposit over the life of the account.

Each of these products involves different types and levels of risk. Therefore, in addition to having strong policies, procedures, and controls, a savings association involved in credit card lending must have a well-defined strategy for each product line it offers.

Subprime Lending

Savings associations may choose to target their credit card lending activities to subprime borrowers, including borrowers that have weakened credit histories or severe credit problems such as charge-offs, judgments, and bankruptcies. Such loans have a higher risk of default than loans to prime borrowers.

Since lenders typically charge a premium for the added risk of default, subprime loans can generate more income than standard risk loans, provided that the lender has accurately estimated default and loss rates and priced the loans accordingly. While responsible subprime lending can expand credit access for consumers and offer attractive returns to financial institutions, the elevated levels of credit and other risks arising from these activities requires more intensive risk management and capital that is proportionate to the risk.

In March 1999, OTS, together with the other banking agencies, issued *Interagency Guidance on Subprime Lending* to provide detailed guidance to examiners on subprime lending activities (See [Appendix A of Handbook Section 217](#)). On February 2, 2001, the agencies issued *Expanded Guidance for Subprime Lending Programs* (CEO Memo 137). This expanded guidance discusses supervisory expectations for the ALLL, regulatory capital, classification of risk, documentation for re-aging, renewing or extending delinquent accounts, and regulatory expectations for the review and treatment of potentially abusive lending practices.

While this handbook section discusses credit card lending in general, savings associations engaging in a subprime credit card lending program will be expected to establish ALLL and hold capital in accordance with the requirements set forth in the 2001 Expanded Guidance (CEO Memo 137). They are also expected to establish a risk management system commensurate with the risk of the lending activity and that conforms to the interagency guidance.

Roles of Savings Associations

Savings associations can have three major roles in credit card lending: a card issuer, a merchant acquirer, or an agent. A card issuer assumes responsibility for solicitation, issuance, servicing, and collection of the accounts. A merchant acquirer collects deposits related to credit card transactions for the merchants and assumes some risk related to customer charge-backs. Charge-backs occur when a customer refuses to acknowledge a charge, claiming either a problem with the goods or services received or the validity of the charge itself. If a business that has been granted merchant privileges has many charge-backs, yet does not have sufficient resources to pay them, the bank that issued credit card privileges to the merchant may incur all or a portion of the charge.

An agent is the most limited form of participation. An agent solicits applicants for an issuer's credit card program without assuming any credit or transaction related risks, and may act as a depository for merchants.

CREDIT CARD OPERATIONS

Credit card operations include numerous activities that the issuer can separate and perform by itself or contract with third-party servicers. A savings association may perform some or all of the following functions:

- Screening and solicitation of cardholders.

Credit card operations include numerous activities that the issuer can separate and perform by itself or contract with third-party servicers.

- Underwriting/credit score modeling.
- Issuance and embossing of cards.
- Solicitation of merchants to accept cards.
- Acceptance and accounting for merchant deposits.
- Payment and statement processing.
- Performing collection activities.

Underwriting and Account Acquisition

Issuers originate credit card accounts in three ways: preapproved offers, approval upon application, and portfolio acquisitions.

Preapproved offers

Preapproved offers are solicitations of credit card accounts to a preselected group of prospective applicants, either by direct mail or by telemarketing. Savings associations select these applicants either from their current borrowers or, more commonly, through the purchase of a list of individuals from a list vendor or credit bureau. These lists often comprise individuals who meet specific institution criteria. Factors used to determine if an individual meets the criteria include credit score, geographical area, income, or card usage. The primary advantages of preapproved offers are higher response rates and faster application processing, making marketing more efficient. However, consumer laws restrict the ability of issuers to deny credit to preapproved applicants. Therefore, it is important that an association carefully screen prospective applicants to whom it sends preapproved offers.

Approval Upon Application

An issuer may also approve an account after it receives an application. In this method, issuers solicit applicants by mail, telemarketing, “take-one” applications, or through media advertisements. The issuer then processes completed applications using its underwriting criteria and makes a decision to grant or deny the account. Issuers may use a judgmental process, an automated scoring system, or a combination of both to make the credit decision. In each case, it is important that the issuer have well-defined credit approval criteria to ensure that underwriting standards are appropriately and uniformly followed.

Savings associations should typically obtain and consider the following credit factors from the application and credit report. They are important elements in any credit card underwriting policy or credit scoring model.

- Length of time in a credit bureau file.

- Types of credit in file (i.e., mortgages, bank cards, department store credit).
- Payment status of current debt.
- Number, severity, and recency of past delinquencies.
- The existence and amount of past collections or judgments.
- The existence of bankruptcy filings.
- The number and balances of bank cards currently outstanding.
- The number of inquiries from other lenders in the past six months.
- The applicant's debt to income ratio and/or estimated disposable income (typically not available from the credit report).
- The applicant's income and job stability.

When using a credit scoring system, many of the aforementioned elements are factored into the applicant's credit score.

Credit Scoring Models

Most issuers now rely on credit scoring models to evaluate the credit risk of applicants. The issuer uses these scores, along with other selected criteria, to develop lists of potential applicants, make credit decisions, and/or to evaluate accounts once they have issued the cards. Credit scoring models use complex scoring algorithms to evaluate credit bureau data, applicant information, and past experience with borrowers. Lenders use the resulting scores to predict the number of accounts within a selected population that are likely to become seriously delinquent or be charged off. Savings associations and scorecard developers use extensive statistical testing of previously originated accounts to develop these models. Associations and vendors develop scoring models by observing the relationship between the initial information on those accounts and their performance over time.

Credit scoring models can range from the following:

- Generic models based solely on credit bureau information from a wide range of applicants.
- Custom-designed scorecards that incorporate bureau information, applicant provided information, and the lender's own payment experience with its borrowers.

Savings associations can also develop their own scoring models to estimate default rates, bankruptcy, other cardholder behavior, and portfolio profitability. The institution or model developer must periodically retest the models to ensure that they continue to accurately predict portfolio performance.

Because the credit card market changes rapidly, borrower attributes that have successfully predicted performance in the past may become less reliable over time. Model developers should revalidate their models frequently and provide “odds charts” for management to evaluate the models. Odds charts list the statistical likelihood that borrowers within a particular credit score range will become seriously delinquent. Management should also compare the savings association’s actual experience of accounts granted using such scoring systems with the results predicted by the model.

Scoring models take the available credit information in various combinations, weight it according to its importance, and arrive at a final score. Management then sets additional parameters, such as score cut-offs or minimum income, to select a group of applicants for solicitation. When the association receives the applicant’s acceptance of the card offer, it should perform a post-screening analysis by rescoring and reevaluating the account based on the updated information.

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A significant deterioration in the applicant’s score or an increased use of credit may warrant a rejection of the account or a limitation on the offer. The association may also use the updated information to select a line assignment (of how much credit to grant) for the account. Appropriate assignment and management of the credit line amount are important factors in controlling losses. (See Account Management in this Handbook Section.)

To protect against fraud, associations should match names, addresses, and social security numbers in the credit report and application before it approves or opens an account.

Testing Marketing Strategies

Due to the significant credit risk involved and the rapidly changing nature of the credit card environment, the association should carefully plan and test its solicitation strategies prior to full implementation or “roll-out.” The association should test such strategies (such as changing a score cut-off or offering “teaser-rate” products) on a smaller representative sample of accounts prior to mass solicitation. Management should ensure that policies and procedures exist to control the level of risk associated with such tests. The sample size should depend on the association’s size, condition, and capital level.

Policies should require management to prepare and analyze profitability projections for each test and to establish procedures to limit tests to an appropriate amount. Associations should terminate tests that produce undesirable accounts.

Financial institutions often compete by offering products with low introductory “teaser” rates and no annual fees. They also target balance transfers from a cardholder’s other accounts. Improper assessment of the credit risk of such accounts could result in unprofitable business or losses due to the high and immediate usage of the accounts. Solicitation strategies should also include a consideration of the effect of balance transfers to other card issuers. An issuer may have to extend teaser rate periods to

retain balances or face losing accounts, causing a product to be much less profitable than projected. Moreover, losing a significant portion of “good accounts” will heighten the risk profile of the remaining accounts and likely result in higher than expected charge offs as a percentage of the portfolio.

Proper testing and analysis of account behavior can mitigate the adverse effects of these problems. Savings associations should maintain records of profitability analyses.

Portfolio Acquisitions

Savings associations sometimes acquire credit card accounts from other issuers through bulk acquisitions to quickly expand an existing program, take advantage of excess servicing capacity, and/or diversify their product lines or geographic markets. Savings associations should have strong portfolio acquisition policies, procedures, and controls to ensure that each prospective portfolio is properly assessed and valued. Management should properly evaluate the portfolio’s credit characteristics, performance, legal structure, and the seller’s operation.

The acquirer should understand the seller’s operations to ensure that it can reasonably integrate the accounts with its own. Management should support account purchase offers with a well-documented due diligence process as well as a performance and profitability analysis of the portfolio. The due diligence should include, among other things, portfolio-wide performance and credit score analysis as well as a representative sample of individually reviewed accounts using updated credit bureau information. The association should also have sufficient control systems in place to ensure that it consistently follows its acquisition policies and procedures and that internal audit periodically reviews them.

Management should carefully assess intangible assets created in connection with an acquisition, known as “purchased credit card relationships” (or PCCRs), and document the financial analyses and assumptions used in valuing them. PCCRs represent a premium paid for credit card accounts and reflect the benefits associated with the ongoing opportunity to lend to and otherwise do business with account holders. PCCR premiums have been ten percent or higher. However, the value of the premium paid, if any, should be based on conservative and realistic assumptions about the profitability of the accounts.

The purchase price of a portfolio (and any PCCR) is based on various factors or “drivers” that, in the aggregate, determine the cash flows from the portfolio.

Examples of drivers include the following:

- Portfolio yield
- Fee income
- Attrition rates
- Charge off rates

- Processing and overhead costs
- Funding costs
- Fraud costs

Valuations are based on the discounted present values of the future net cash flows generated by the purchased accounts. Savings associations should use reasonable and supportable discount rates to estimate the value of the future net cash flows. They should perform re-valuations quarterly. They should base the current value of PCCRs on periodic analyses of the account relationship, account balance, and profitability.

The association's accounting policy for PCCRs should include:

- Parameters for PCCR valuation models.
- Frequency of valuations (usually quarterly).
- Amortization standards for the life and benefit of the account relationship and the maximum allowable amortization period.
- Impairment determination.

Associations should amortize PCCRs over the estimated useful lives of the purchased accounts. Generally accepted accounting principles (GAAP) require that amortization periods not exceed ten years; however, since most prepayments occur in early years, savings associations should use an accelerated amortization schedule commensurate with the effective life of the purchased portfolio.

Management should be able to demonstrate that the credit card and other products related to PCCRs are ongoing and profitable.

Management should be able to demonstrate that the credit card and other products related to PCCRs are ongoing and profitable. Otherwise, you should presume that the valuation assumptions pertaining to the PCCRs were overstated or are now invalid, and the association must charge off excess/unsupported PCCRs.

Regulations limit the inclusion of PCCRs in regulatory capital, and require that their carrying value not exceed the lower of cost or fair value, less selling costs, which must be evaluated at least quarterly. Specifically, the association cannot include PCCRs in the calculation of tangible capital and may only include PCCRs up to a maximum of 25 percent of core capital. Complete details regarding these limitations and guidelines are specified in the capital regulations at 12 CFR Part 567.

Consumer Considerations

Unfair or Deceptive Acts

Savings associations should ensure that credit card marketing, as well as account management practices, do not involve practices that may be unfair or deceptive acts or that may expose the association to excessive compliance and reputation risks. In particular, management should carefully scrutinize the following types of practices:

- The practice of soliciting credit cards with credit limits “up to” a maximum dollar amount, when that credit limit is seldom granted, or when the “up to” maximum for targeted consumers who have limited or poor credit histories is significantly higher than the credit limit they would likely receive.
- The practice of using promotional rates in credit card solicitations without clearly disclosing the significant restrictions on the applicability of or fees associated with those rates.
- The practice of increasing a cardholder’s annual percentage rate when the circumstances that would trigger the increase have not been fully disclosed.
- The practice of not adequately informing consumers of the costs, terms, risks, and limitations of the product being offered. For example, offering secured credit card products in which the security deposit or applicable fees are charged to the card. As a result, the changes substantially reduce the amount of initial available credit and card utility to the consumer, contrary to representations made.

Bankruptcy Act Truth-in-Lending Act (TILA) Amendments

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Bankruptcy Act) amends the TILA’s disclosure requirements for credit cards.¹

Applications and Solicitations

For open-end credit secured by a dwelling, it will no longer be sufficient to recommend that the borrower consult with an advisor concerning the deductibility of interest. The Bankruptcy Act requires specific disclosures concerning limitations on tax deductibility of interest where the total of all extensions of credit secured by the dwelling exceed its fair market value. Advertisements and applications must contain these disclosures.

There are also new disclosures when a creditor offers introductory rates. Generally, the application or solicitation to open a credit card account offering an introductory rate must use the term “introductory” in immediate proximity to each use of the temporary APR. In close proximity to the

¹ These requirements become effective 12 months after the Federal Reserve publishes a final rule implementing them.

first use of the introductory APR, the creditor must state when the introductory rate will end and either the new APR that will apply (if fixed) or an APR that was used within the last 60 days (if variable). If the creditor can revoke the temporary APR, it must include a general statement of the grounds for revocation and clearly and conspicuously disclose the post-revocation APR.

The Bankruptcy Act also has provisions relating to Internet credit card solicitations. Required disclosures made through the Internet must be clear and conspicuous, readily accessible to consumers, in close proximity to the solicitation, and updated regularly.

Periodic Statements

The Bankruptcy Act requires creditors to include minimum payment disclosures on periodic statements. The disclosurers must explain the time it would take to pay off a balance accruing interest at 17 percent. The examples vary depending on the minimum payment required by the creditor. If the creditor requires minimum payments of 4 percent or less, the example must assume a balance of \$1000 and a 2 percent minimum payment. If the creditor requires a minimum payment of more than 4 percent, the example assumes a balance of \$300 and a minimum payment of 5 percent. The creditor may use an interest rate greater than 17 percent in its example and a creditor requiring a minimum payment of greater than 4 percent may use an example based on 2 percent minimum payment.

If the creditor imposes late payment fees, the billing statement must clearly and conspicuously state the date the payment is due or, if different, the first date on which it will charge the late payment fee.

Account Termination

The Bankruptcy Act prohibits a creditor from terminating an account prior to its expiration date because a consumer does not incur finance charges. A creditor can terminate an account if it is inactive for three or more consecutive months.

Future versions of the TILA handbook section will incorporate these changes.

Account Management

A successful credit card operation does not stop with the acquisition of the accounts. Because marketing and data processing costs incurred in acquiring the accounts are high, management must be effective in retaining good accounts, minimizing losses on poor performing accounts, and taking prudent actions to enhance portfolio profitability.

Credit card issuers manage credit card accounts in a number of ways, including:

- Making credit line increases/decreases, with appropriate authorizations.
- Adjusting allowable over-limit amounts, with appropriate authorizations.
- Suspending charging privileges.

- Adjusting rebate programs.
- Initiating various campaigns to promote usage.
- Initiating monitoring and anti-fraud techniques.

You should understand the savings association's account management strategies through a review of its account management reports and discussions with senior managers.

Effective account management depends on accurate monitoring and analysis of the portfolio. Management must have timely information about trends in factors affecting the credit quality of the accounts, including delinquencies, charge offs, over-limit accounts, bankruptcies, and fraud losses.

Management must also actively manage profitability. For example, some issuers use risk-based pricing, where they change interest rates and fees based on changes in the status of the account or in the cardholder's credit profile. Management should monitor profitability factors such as average yield, average balance, credit line usage, and account attrition. Larger operations often use behavioral modeling to predict losses and the profitability of groups of accounts.

Many issuers use automated account management strategies, allowing credit decisions (such as automatic 20 percent line increases or ten percent over-limit approval) to be implemented on a large number of accounts with minimal manual intervention. As with account acquisition, however, prudent management will test such strategies on a smaller number of accounts prior to mass implementation. Issuers often use "champion/challenger" scenarios to test various account management strategies against one another. In this scenario, the institution develops new "challenger" strategies and tests them against a current successful "champion" strategy. If a challenger proves to be more effective, the institution adopts it, and it becomes the new champion. This allows management to continually refine its account management practices and to test strategies prior to full implementation.

Managing problem accounts is important and we discuss it in the next section, Collections and Workouts.

Although marketing typically drives the timing of account management initiatives, the risk management or credit policy function should establish the credit criteria used in acquiring accounts. If the program involves extending a significant amount of credit or a deviation from established underwriting practices, senior management should review and approve changes before implementation.

In January 2003, OTS, together with the other banking agencies, issued joint guidance relating to the account management of credit card lending. The "*Account Management and Loss Allowance Guidance*" addresses several important issues relating to the management of credit card portfolios, including: credit line management, over-limit practices, minimum payment practices and negative amortization, workout and forbearance practices, income recognition, loss allowance practices, and policy exceptions. (See [Appendix A](#).)

On the issue of minimum payment practices and negative amortization, the guidance states, “Agencies expect lenders to require minimum payments that will amortize the current balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower’s documented creditworthiness. Prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality raise safety and soundness concerns and are subject to examiner criticism.”

While some lenders require a minimum payment (e.g., two to three percent of the outstanding balance) that is sufficient to cover interest and some amortization of principal, other lenders specifically require a minimum payment that is sufficient to cover interest and fees along with a one percent amortization of the principal balance. The latter practice ensures the amortization of principal. Thus, monthly minimum payments should cover at least a one percent principal balance reduction, as well as all assessed monthly interest and finance charges.

Management should have in place systems to monitor compliance with the *Account Management and Loss Allowance* guidance, including reports detailing any negative amortization in the portfolio. Account management practices should ensure that controls are in place so that the performing segment of the portfolio is adequately amortizing.

Also, in December 2002, OTS, together with the other banking agencies, issued an advisory to clarify the appropriate accounting treatment for banks and savings associations that securitize credit card receivables and record Accrued Interest Receivable (AIR).² The guidance contained in this issuance is consistent with GAAP as specified in Financial Accounting Standards Board Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), and is applicable to institutions preparing regulatory reports filed with the federal banking agencies.³ The agencies consulted with the staff of the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) in developing this guidance. (See [Appendix B](#).)

Collections and Workouts

The increase in bad debt and fraud losses from credit cards have been attributed to relaxed underwriting standards by some issuers (including initiating subprime credit card programs), poor or imprudent account management practices, continued mass marketing of cards in a saturated market, increased credit card and other debt by consumers, and increases in consumer bankruptcies. An increase in losses can also be attributed to collection staff, systems, and controls that have not kept pace with new account generation.

² For information and guidance on the regulatory capital treatment of the AIR asset, see the “Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations,” dated May 17, 2002. (See CEO Memo 160)

³ These regulatory reports include the bank Consolidated Reports of Condition and Income (Call Report), and the Thrift Financial Report (TFR).

An effective collection process is a key component of controlling and minimizing credit losses. Savings associations must manage the process effectively at each operational level. The problems associated with an inadequately managed collection function include the following:

- Reduced earnings caused by increased loan losses and reduced recoveries.
- Reduced earnings caused by higher collection expenses.
- Inaccurate or untimely communications to senior management and the directorate.
- Inaccurate reporting of past due and charged-off loans leading to imprudent management decisions.
- Improper use of re-aging (changing the delinquency status of an account), fixed payment/workout programs, or other collection practices.
- Insufficient allowance for loan losses caused by weak MIS, inaccurate past due figures, and the improper use of re-aging, fixed payment programs, etc.
- Inadequate audit trail of collection and recovery activities.
- Poorly trained employees, resulting in loss of productivity, collections, and recoveries.
- Violations of law and regulations.

An effective collection process is a key component of controlling and minimizing credit losses.

Collection is labor intensive and is increasingly difficult to manage properly due to the size and complexity of the credit card business. Management should use current and historical information to formulate a strategy to optimize its collection efforts. In general, such strategy should attempt to direct the department's efforts to accounts with the greatest risk of loss and the greatest potential for collection.

Close supervision of the collection staff is critical. Supervisors should regularly review each collector's performance in areas such as number of contacts made, time per contact, and promises to pay versus dollars received. Management should also determine and use the optimum number of accounts per collector, which is a crucial factor in preventing and controlling delinquencies and charge offs. Surveys of collection departments report that the average number of accounts per collector for large credit card operations is approximately 300. This number can vary widely, however, depending on the type of account (bank card or retail, prime or subprime) and the technology used. Also, front-end (early delinquency) collectors may handle more accounts, while back-end (severe delinquency) collectors typically handle fewer accounts.

Collection strategies determine which accounts collectors work on, the timing of collection activities, and the manner of the contact (for example, phone calls, collection letters, and legal letters). In many

savings associations, collection strategies rely on models that track the past behavior of borrowers to predict the likelihood of collection. Some associations also use champion/challenger collection strategies.

Armed with such information, management can effectively direct collection efforts with an emphasis on the dollars at risk of default. Management must maintain close control over collection strategies because seemingly minor changes can significantly affect the dollar amount collected. You should review the collection strategy process and reports, and discuss them with management. You should also have a general understanding of the technologies employed by collection departments. In addition, you should review the collection training program. Well-managed operations should include formal training programs for new employees that can include both classroom and on-the-job training.

Account management also includes developing and managing workout practices, such as re-aging and managing fixed-payment programs, and Consumer Credit Counseling Service (CCCS) programs. How management supervises and controls these programs determines how the association should classify and report the accounts to OTS and what focus it should place on collection efforts. (See a discussion of CCCS programs later in this section.)

Re-aging

The credit card industry often uses re-aging, sometimes referred to as “curing” or “rollback.” With re-aging, the bank changes the delinquency status of an account after receiving some, but not all, payments required to bring the account current. Re-aging applies to both forward and backward changes, and often occurs in both the customer service and collection areas. For example, a payment on an account subsequently returned for nonsufficient funds would result in re-aging the account into a more severe delinquency status. Conversely, the savings association may bring a delinquent account current if the borrower showed a renewed commitment to repay the account.

More institutions are adopting the practice of re-aging a delinquent account to current status, after the borrower has made partial payments. This practice serves to avoid reporting performing accounts perpetually delinquent and to help customers who demonstrate a renewed willingness and ability to repay their loans.

An improperly managed re-aging program can lead to pools of problem receivables. It can also understate delinquency and charge-off levels, and impede accurate analysis of the ALLL.

Savings associations should establish some minimum criteria, such as a requirement that an account holder make three consecutive monthly payments, before a delinquent account is re-aged to a current status. The underlying philosophy is that

three consecutive payments show the customer’s capacity and willingness to pay. An improperly managed re-aging program can lead to pools of problem receivables. It can also understate delinquency and charge-off levels, as well as impede accurate analysis of the allowance for loan and lease losses (ALLL).

In June 2000, the Federal Financial Institutions Examination Council (FFIEC) published the *Revised Uniform Retail Credit Classification and Account Management Policy* (Account Management Policy). The Account Management Policy establishes criteria for all federally regulated banks and savings associations and their operating subsidiaries for classifying retail credit accounts based on delinquency status (rather than a detailed credit analysis of each account). We discuss the Account Management Policy statement more fully in [Handbook Section 217, Consumer Lending](#), and [Section 260, Classification of Assets](#).

Because re-aging and other workout programs affect delinquency status, the Account Management Policy establishes criteria for the number of payments the borrower must make before an institution can re-age an account. The Account Management Policy also sets limits on the number of times an institution can re-age an account within one and five-year periods. In addition, the Account Management Policy specifies that:

- Institutions that re-age open-end accounts should establish and adhere to reasonable written re-aging policies. An open-end account eligible for re-aging should exhibit the following:
 - The borrower shows a renewed willingness and ability to repay the loan.
 - The existence of the account for at least nine months before allowing a re-aging.
 - The borrower makes at least three minimum consecutive monthly payments or the equivalent lump sum before an account is re-aged. The institution may not advance funds to the borrower for this purpose.
- Institutions should not re-age accounts more than once within a twelve-month period (that is, at least twelve months must have elapsed since a prior re-aging) nor twice within a five-year period.
- Institutions may re-age an account after the borrower enters a workout program, including internal or third-party debt counseling services, but only after receipt of at least three consecutive monthly payments or the equivalent cumulative amount. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the re-aging limits described above.
- For open-end credit, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees). However, the institution may not extend new credit to the borrower until the balance falls below the designated predelinquency credit limit.

As indicated, savings associations should establish appropriate written policies and procedures to govern their re-aging practices. The re-aging policy should address:

- Approval and reporting requirements.

- Age of the account before it is eligible for re-aging.
- Delinquency levels eligible for re-aging.
- Status of the account after being re-aged, i.e., closed, blocked, or open.
- Time limitations between re-aging as well as any limitations on the number of re-aging permitted for each account.
- Consideration of the borrower's overall capacity to repay (factors such as income, length of employment, and other debts) in the re-aging decision.
- Number and amount of payments required to qualify for re-aging.

You should determine if the association's re-aging policy complies with the Account Management Policy.

Accurate reports for the re-aging program are essential. At minimum, management should review regular reports that show both the number and dollar amount of newly re-aged accounts (current month) and those re-aged within the last 12 months. Management also should monitor cumulative historical data that shows the performance of re-aged accounts over time. Without such information, management cannot effectively determine how re-aging affects the association's asset quality. For example, if the association ultimately charges off a large percentage of accounts within 12 months after re-aging, management should assess whether the results (dollars collected prior to charge off versus collection costs) justify the re-aging policy or highlight the need for a revised policy.

Fixed-Payment Programs

Another practice often used to facilitate collection is the fixed-payment program (also known as cure, zero, or reduced-interest programs). Savings associations target such workout programs to borrowers with prolonged or severe credit problems to work with the borrower, to encourage continued repayment, and to minimize loss.

While most associations offer one or more fixed-payment/workout programs, program characteristics vary greatly within the industry. Programs typically consist of a fixed-payment amount, a lower minimum payment percentage, and/or a reduced interest rate for a specified period of time (usually 12 months).

As an additional incentive, institutions often

re-age the accounts to current status after they receive three or more consecutive payments at the newly agreed upon rate/amount. You should determine if any such re-aging comply with the association's written policies as well as the Account Management Policy.

Management should institute strong controls and ongoing monitoring and perform regular analyses of the programs to determine whether they ultimately benefit the association.

Loss rates associated with fixed-payment programs are generally higher than those of the total portfolio because of the borrowers' financial problems. The savings association should have policies that specify the terms and conditions of fixed payment programs, such as qualifications for entering the program and how long an account can stay in the program. Management should institute strong controls and perform ongoing monitoring and analyses of the programs to determine whether they ultimately benefit the association. Again, any re-aging or change in the delinquency status or reporting of the account should be part of an overall policy that comports with the Account Management Policy.

Consumer Credit Counseling Service

As part of their collection efforts, many financial institutions also work with the Consumer Credit Counseling Service (CCCS) or other credit counseling services. CCCS is a nonprofit organization that functions as an independent third party to help consumers work through their financial difficulties. CCCS funds its operations by retaining a percentage of each dollar collected. Properly managed, CCCS programs aid both the consumer and the credit community.

A consumer's acceptance into the CCCS program is based on a CCCS counselor's determination that his or her financial situation is salvageable. If accepted, the consumer must agree to cancel all credit cards, develop and adhere to a budget (with counselor guidance), and make debt payments as agreed. CCCS then notifies creditors that it has accepted the consumer into the program and negotiates reduced payment terms with each creditor. Terms vary by creditor, with some requiring the full payment amount and others reducing interest and principal payments significantly in an attempt to stop the account from going to loss. Consumers then make their payments directly to CCCS, which pays the creditors.

Upon receiving confirmation of a consumer's acceptance into the program, creditors will normally re-age delinquent accounts to a current status after receipt of those payments. At this point the creditor generally waives any late and over-limit fees, and ceases all collection efforts as long as the account complies with the renegotiated terms. If an account goes delinquent again for any significant period of time, it usually reverts to the original contract terms, collection efforts commence, and the creditor drops the account from the CCCS program.

Savings associations should have a policy regarding CCCS accounts and appropriate systems to properly account for related transactions with CCCS. An association typically assigns an individual to supervise and monitor its CCCS accounts. The individual should ensure that the association properly identifies all CCCS accounts to enable accurate reporting of CCCS delinquencies and charge offs. The association should incorporate CCCS information into the appropriate loan risk grades and into ALLL calculations. In addition, any re-aging or change in the delinquency status or reporting of the account should be part of an overall policy that comports with the Account Management Policy.

When loan terms, such as the number or amount of payments, principal balance or the interest rate, are modified through either fixed payment programs or CCCS programs, the value of the discounted cash flows of the restructured loan may be less than that the loan's carrying value. When material, associations should adjust the carrying value of such loans in accordance with GAAP.

Management Information Systems for Collections

The collections area typically requires many management information system (MIS) reports to track and manage loan performance, asset quality, and default risk. Regular MIS reports for each collection program are an essential part of proper portfolio supervision. Management should regularly review key MIS collection reports and be able to identify and quantify all collection program specifics, such as delinquency, the number of re-agings on an account, and the percentage of re-aged accounts that the association must ultimately charge off.

Reports should track the performance of each card issue against the performance of the credit card portfolio as a whole. In addition, where the association uses special collection efforts, such as re-agings or workout programs, including CCCS programs, it should compare collections under those programs with performance under the association's standard collection program. If a program is not working effectively, management should discontinue or modify it. You should evaluate MIS reports for pertinent information and accuracy, criticize the absence of necessary MIS reports, and ensure that the association takes steps to initiate corrective action.

One report, called the rollover, breakage, or roll-rate report, is particularly important. Through this report, management can review the number and dollar volume of accounts that move to charge off from each delinquency category. With this information management can predict the delinquency based (not bankruptcy based) charge-off rate as far as six months into the future. In addition, this report can aid management decisions regarding collection staffing levels.

Delinquency and charge-off reports serve as valuable tools in evaluating collection effectiveness. Management should review overall portfolio reports as well as reports on a program-by-program basis. Many credit card operations report delinquencies using two formats: end-of-month (EOM) and sum-of-cycle (SOC). Associations use EOM delinquencies for Thrift Financial Report purposes and to evaluate outstanding delinquencies at month-end as a percentage of outstanding receivables. SOC reports compute delinquencies for each billing cycle, and then aggregate these cycles to determine delinquency for the total portfolio. Unlike EOM reports, the SOC reports ignore the "cleaning up" of delinquencies between the end of the cycle date and the end of the month.

Because new credit card accounts often take time to become seriously delinquent, management may find reports that analyze delinquencies and charge offs on a "lagged" basis useful, especially if a portfolio has experienced significant growth. Such analyses take current delinquency and charge-off figures as a percentage of receivables that were outstanding six or 12 months ago. Also, a "block" or "status code" report provides valuable information for reviewing the composition of the portfolio; (i.e., the number and dollar amount of fixed payment, bankruptcy, fraud, deceased, and canceled accounts).

As discussed previously, a review of re-aging reports is a critical step in the evaluation of the portfolio. Other reports could include actual versus budgeted performance, changes in collection strategies, and performance of behavioral or other scoring models.

Delinquency, Classification, and Charge-Off Policies

Management should regularly assess the quality of the portfolio through a variety of means including a review of past due, charge off, and profitability reports. Management's ability to quickly identify trends in the portfolio and to react appropriately is a critical element in proper and consistent credit card management. In associations lacking a timely charge-off program, loss ratios may be meaningless for

Management's ability to quickly identify trends in the portfolio and to react appropriately is a critical element in proper and consistent credit card management.

periods of less than one year. As a result, management may not become aware of downward trends until year-end or until examiners initiate charge offs. This delays recognition of problems as well as the implementation of necessary corrective action.

You should determine how management charges off contractual and noncontractual losses such as bankruptcy, fraud, and deceased accounts. Where the association charges off delinquent credit card loans in the normal course of business, under a policy consistent with OTS regulatory guidelines, you will not likely need to require additional charge offs as a result of your examination.

In accordance with the Account Management Policy, associations should:

- Classify open-end accounts that are 180 days or more delinquent as Loss.
- Classify open-end accounts that are 90 or more days past due as Substandard.
- Charge off bankruptcy, fraud, and deceased accounts in a timely manner:
 - Associations should charge off losses from deceased open-end accounts at the earlier of when the loss is determined or no later than when the account becomes 180 days contractually delinquent.
 - Unless the association can clearly demonstrate and document that repayment on an account is likely to occur, it should charge off accounts in bankruptcy within 60 days of receipt of notification of filing from the bankruptcy court or within 180 days, whichever is shorter. The association should take the charge off by the end of the month in which the time period lapses. In the case of fraudulent accounts, the association should place a block on the account until it can complete its fraud investigation (usually within 90 days). Once the association verifies the existence of fraud, the association should charge off the account as noted below.

Recoveries

Recoveries represent collection activities conducted after the charge off of an account. The rate of recovery depends on many factors, including:

- Charge-off policy.
- Previous collection efforts.
- Depth and experience of staff.
- Adequacy of systems and controls.
- Use of technology.

An association generally conducts recovery activities internally. Then, after it has worked the account for several months, it may outplace the account to a collection agency. When outplacing accounts, the association must maintain strict controls and appropriate systems to evaluate each agency's performance. Collection agencies receive a percentage of the dollars collected, typically between 30 percent and 60 percent. The amount varies based on whether the agency is the primary (the first agency to work the accounts), secondary, or tertiary collector. Fees are lowest for the primary agency (these are the accounts easiest to collect) and highest for the tertiary agency. The association should periodically rotate outplaced accounts among agencies to ensure the servicers actively and appropriately work the accounts.

Fraud Control

Fraud is a continuing problem associated with credit card programs. The very nature of the product, an easily obtainable unsecured line of credit that the consumer manages, makes it susceptible to fraud abuse. The bank card associations, issuers and acquirers, the U.S. Postal Service, and their vendors have been focusing on strengthening systems and controls to reduce fraudulent activities. Because of the advances in fraud detection, fraud losses, measured as a percentage of sales volume, have declined for many issuers.

Fraud is a continuing problem associated with credit card programs--Reporting specific information on types of fraud allows an association to better identify its points of greatest risk.

Fraud can be orchestrated in many ways. Lost or stolen cards and nonreceipt of issued cards represent a large percentage of all fraud reported. The bank card associations track fraud according to type and most issuers follow this or a similar format in reporting

fraud in their internal MIS reports. Reporting specific information on types of fraud allows an association to better identify its points of greatest risk. If the operation does not distinguish fraud losses by type, discuss the benefits of such reporting with association management.

Credit card issuers should review their average fraud losses to determine if the staff is identifying fraud activities in a timely manner. If the issuer has inadequate systems and controls to identify fraud, this will likely result in the frauds running longer, permitting more transactions, and resulting in higher losses.

Card issuers use some of the following techniques to reduce fraud:

- Sorting mail outside the facility where the mail was initiated.
- Instituting call-to-activate (CTA) requirements where the account holder must call from his or her home phone to activate new and reissued cards.
- Implementing pattern recognition programs and systems to monitor unusual card usage.
- Use of sophisticated fraud detection systems.
- Extending the time in which the institution reissues cards to three years from two years to reduce the number of cards in the delivery system.
- Designating a special group to handle lost or stolen card reports.
- Increasing the level of payment review to include all checks over a certain amount, \$3,000 for example, regardless of whether or not there is a payment coupon.

Most large issuers maintain dedicated staff that perform certain activities required when a cardholder notifies the issuer of a suspected fraud or when the issuer becomes aware of fraud. These activities include:

- Preparing a lost or stolen report from the cardholder and advising the cardholder to destroy additional cards. The report should include all relevant information regarding the fraudulent activity, corrective action taken, and the name of the manager signing off.
- Blocking the account and placing it on an exception file. Each issuer will have its own block codes depending upon its processor.
- Preparing a request to issue new cards to the cardholder.
- Setting up a file for investigation on fraud accounts. This includes requesting draft copies of fraudulent items and challenging the cardholder on questionable items.
- Reviewing and initiating fraud transactions for chargebacks. This includes preparing fraud notifications to bankcard interchange systems such as Visa or MasterCard, investigating and documenting fraudulent cards, and prosecuting, if possible.
- Charging off losses after the account becomes 180 days past due or within 60 days after fraud is determined, whichever is sooner. The issuer subsequently submits losses to Visa or MasterCard for reimbursement on insurance, if applicable.

Management should have adequate controls in place to ensure that association staff recognize fraudulent activities in a timely manner, and appropriately blocks the accounts to prevent further charges. The timing of the block date is important as the vast majority of fraud losses occur on or prior

to the block date and those after the block date have significantly lower transaction sizes. According to industry studies, improvement in authorization and other fraud control measures has materially lowered losses from fraud after the block date.

The Account Management Policy requires associations to charge off fraudulent accounts within 90 days of the discovery of the fraud or 180 days (for open-end accounts), whichever is shorter. The association should take the charge off by the end of the month in which the time period elapses. This period provides the fraud unit with ample time to conduct its investigation.

Savings associations should not re-age fraudulent accounts (as opposed to disputed accounts) at the time of notification or identification to permit the investigation to proceed without reaching the mandatory charge-off period of 180 days contractual delinquency. OTS considers this practice unacceptable.

Allowance for Loan Losses

Methods used to determine the allowance for loan losses related to credit card portfolios will vary among financial institutions. These can range from a simple historical average of loss rates to complex migration to loss analyses. However, the methodology and resulting allowance must conform to the “Interagency Policy Statement on the Allowance For Loan and Lease Losses,” dated December 21, 1993, and the “Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions,” dated July 2, 2001.

As noted in those policy statements, associations should maintain the ALLL at a level adequate to absorb estimated credit losses that they will likely realize on a loan or pool of loans based upon facts and circumstances as of the evaluation date. Associations should base these estimated inherent credit losses on the historical net charge-off rates, adjusted for current economic conditions and trends, as well as changes in lending activities. The losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in GAAP. (See [Handbook Section 261](#) for general guidance on the ALLL.)

For credit card loans, institutions generally maintain the allowance based on outstanding balances, rather than unused lines. This is because credit losses are compared with existing balances, and issuers are able to restrict new purchases and/or close the line to borrowers if credit quality declines. However, poor account management practices, or weak accountholder agreements that allow new charges on delinquent or otherwise troubled accounts, might necessitate an increase in the ALLL for exposure to committed lines. The following factors should be considered when evaluating the sufficiency of the ALLL:

- Recent and historical trends in delinquencies.
- Charge-offs for credit reasons, bankruptcies, deaths, and seasonality factors.
- Current composition of the portfolio.
- Level of recoveries.

Outstanding credit card balances for prime accounts often have a high prepayment speed or turnover rate, usually one or more times per year. This has been the basis for credit card issuers to argue for the six months or less ALLL coverage where the average balance of the portfolio turns over every four to six months. Credit card portfolios of lower credit quality or subprime accounts generally have much slower turnover rates. Portfolios that have higher concentrations of borrowers who only pay the minimum payments or portfolios with high levels of chronically delinquent accounts will have much longer average lives. Therefore, the ALLL should be sufficient to cover expected losses for loans in these higher risk portfolios. While some of these accounts may have shorter average lives due to charge-offs or restructurings, the association should calculate the average life of a segment of loans based upon specific portfolio segmentations with fully supported estimated prepayment speeds.

Keep in mind that the average charge-off rate will be lower for rapidly increasing portfolios, as most new accounts take from 12 to 24 months for serious delinquency to develop and for the association to recognize the losses. Where loss rates are low due to an increase in new accounts, it may be appropriate for the association to use industry average charge-off rates to determine the ALLL.

A rolling analysis generally segments the portfolio into various degrees of delinquency and tracks the roll rate from one delinquency “bucket” to the next over time. Typically, as accounts age, the percentage of accounts that roll to the next bucket e.g., the roll rate, increases significantly. By applying the average roll rates from current account balances to various delinquency buckets, an association can better estimate losses resulting from delinquency in the existing portfolio. In some cases, it may be appropriate to further segment the portfolio, particularly if significant portfolio segments demonstrate materially different loss characteristics.

Diversified lenders might segment the portfolio by major product types, such as gold cards, classic cards, affinity cards, corporate accounts, subprime, and/or secured cards. Financial institutions might also segment portfolios by date of origin (“vintage”), by solicitation, by risk classification, or by geography. Roll rates applicable to each segment would then be applied to balances in the various delinquency buckets in order to estimate losses for each segment. While this roll rate analysis can be useful in predicting losses due to delinquency, associations must also assess the adequacy of the ALLL for losses due to bankruptcy, death, or other reasons that can occur at any level of delinquency.

Whether an association uses a migration analysis or a historical loss rate, it should base its ALLL methodology on the actual loss experience of its portfolio. Associations should analyze losses over a period of two or three years to consider the seasonal nature of the credit card market.

Whether an association uses a migration analysis or a historical loss rate, it should base its ALLL methodology on the actual loss experience of its redundant portfolio.

Management should adjust historical loss experience to reflect current conditions that may affect the current portfolio such as:

- Changes in lending policies and procedures.
- Trends in relevant national or local economies.

- Changes in the nature or volume of the portfolio.
- Material changes in management or staffing.
- Changes in the volume or severity of past due and classified loans.

In reviewing the reasonableness of an association's ALLL methodology for credit cards, make sure that re-aging has not caused an inappropriate delay in reporting delinquencies or charge offs. In addition, determine whether or not the association "purifies" its losses before charging them to the allowance, that is, reversing capitalized interest and fees considered uncollectible against appropriate income accounts, so that charge offs are only for principal balances (purchases and cash advances). Reported charge-offs would therefore exclude accrued and unpaid finance charges and fees. The resulting ALLL would be based upon principal charge offs that do not properly capture these capitalized charges. While this is common practice in the industry, it necessitates the creation of a separate reserve or other methodology to properly reflect uncollectible finance charges and fees. Regardless of accounting practice, ALLL methodology should ensure allowances or reserves cover all estimated uncollectible amounts (principal, fees, interest, etc.).

Profitability Analysis

Credit card accounts generate income in a variety of ways, including interest, annual fees, interchange fees (a percentage of credit card sales paid by the merchant for access to the interchange system), late charges, cash advance fees, and over-limit fees. Some credit card operations also receive servicing fees and residual income from securitized portfolios. Interest rates are generally higher than other loans, but can vary significantly depending upon product type, borrower risk profiles, competition, and state usury laws. Overall, credit cards are among the highest gross yielding assets held by financial institutions. However, they also generate higher charge offs than other loan types.

Overhead expenses are also higher for credit card operations than many other lines of business due to small relative loan balances and a higher number of transactions per account. Credit card operations involve significant expenditures for marketing/account acquisition, data processing, servicing, collections, and facilities and equipment. Therefore, it is important that management perform profitability analyses of the credit card operations separate from the association's other lines of business. Where appropriate, management should separately analyze profitability of different segments of the credit card portfolio.

Good management information systems, including timely and accurate reports, are crucial to ensuring that the association adequately assesses profitability.

Rewards/Rebate Programs

As a result of increased competition, many issuers offer some type of reward or rebate program to cardholders. Rewards/Rebates include cash, free gasoline, free phone time, free airline tickets, discounts on car purchases, and numerous other offers. Associations offering such programs, or

participating with a partner in a program, must evaluate the liability represented by the rebate or reward redemption amount. Associations must establish a liability account, or reserve, in accordance with GAAP based upon management's estimates. Associations should adjust the liability associated with these marketing programs on a regular basis due to changes in program assumptions, including number of cardholders in the program, general economic conditions, actual contract costs, current number of rewards/rebates earned or redeemed, and program changes. You should review the association's reserve methodology for adequacy.

SECURITIZATION

The issuance of asset-backed securities (ABS) provides a major source of funding for larger credit card issuers. (A more detailed discussion on Securitizations is in Handbook Section 221, Securitizations.) Issuing ABS certificates with rates correlated to the accounts in the trust allows management to manage interest rate risk. Credit card operations can generate substantially higher returns on assets than traditional thrift assets. The returns appear even higher for associations that remove credit card balances from the books through securitization since they continue to receive the residual income as seller/servicer.

However, do not rely on a return on book assets analysis for such associations. The components of this residual net income for balances sold are essentially the same as accounts on the association's books, less the interest paid to the investors. Therefore, profitability analyses of credit card operations are performed on a managed assets basis rather than an on-balance-sheet basis. This allows more accurate analyses of profitability, cost allocation, collections efficiency, delinquency and loss trends, interest rate risk, and other performance factors affecting the credit card operation. It is expected, however, that the MIS track both on-balance sheet and managed asset portfolio.

Such profitability analysis also allows proper comparison to other issuers. Market data for comparison can be obtained by reviewing credit card trust prospectuses from other issuers who securitize. In addition, Visa and MasterCard publish a variety of statistics for participating issuers on a monthly basis.

Trust Structure

Basic credit card securitization involves the transfer of a number of loan receivables to third-party investors through the issuance of asset-backed securities. If the securitization is accounted for as a sale in accordance with Statement of Financial Accounting Standards No. 140 "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*," the credit card receivables are removed from the balance sheet. Historically, financial institutions established credit card securitizations in a "stand-alone" trust structure, meaning that receivables from specified accounts were assigned for the entire life of a trust. In 1988, large issuers began using a "master trust structure," which allows issuers to add receivables from new accounts periodically and to issue multiple series from a common pool of receivables. In addition to adding receivables to issue new series, the master trust structure allows the issuer to add receivables to replace balances lost by cardholder attrition and/or to maintain the characteristics of the existing pool.

To protect investors, most credit card securitizations have specified “trigger” events that can cause early amortization of the trust. Early amortization begins if the receivables fail specified performance or loss measures. Each series in a master trust may have different trigger events that may or may not cause early amortization in other series.

Since early amortization requires the issuing institution to repay investors earlier than anticipated and can take one year or less, it can cause serious liquidity problems. It can also damage the issuer’s reputation in the investment community, limiting further credit card securitizations. It is therefore very important for management and the directorate to be aware of triggers and have reporting procedures in place to monitor the performance of each series issued. You should review these reports and assess the adequacy of the association’s monitoring procedures.

Management must obtain sound legal, accounting, and tax advice in planning a credit card securitization program. When properly structured and operated, associations may treat credit card securitizations as sales, allowing removal of assets from the balance sheet and improving capital and performance ratios. Under sale accounting, the association recognizes monthly profit from these accounts as servicing/other income. With the implementation of SFAS No. 140, the association recognizes estimated net profits over the life of these receivables at the time of transfer.

When properly structured and operated, associations may treat credit card securitizations as sales, allowing removal of assets from the balance sheet and improving capital and performance ratios.

If it intends to obtain sale treatment under GAAP, the association must carefully structure the trust in accordance with applicable GAAP guidance. In addition, the association should base profits from the sale of ABS on realistic and supported assumptions for delinquencies, operating expenses, prepayments, and losses. Management should reevaluate these assumptions at least quarterly and revise the carrying value of the underlying assets when material changes occur.

Since credit cards are revolving lines of credit, savings associations structure securities backed by credit cards differently than those secured by traditional association assets, such as mortgages. Securitizing associations place credit card accounts into a trust and typically sell up to 96 percent of the outstanding receivables to investors as an ABS. Under the ABS agreement, the issuer typically must retain at least four percent participation.

The association sells only the outstanding receivables, not the accounts, to the investors. There is typically a “revolving” period, during which the investor receives only interest, and an “amortization” period, when investors receive both principal and interest.

During the revolving period, the investors’ principal amount is held constant since the issuer uses principal repayments and a portion of interest payments by the cardholders to purchase new receivables (new cardholder purchases) generated by the accounts in the trust. The issuer’s ownership interest in the receivables is generally not subordinated, existing to absorb fluctuations in the total balances so that they do not fall below the investor amount. The revolving period typically lasts two to seven years, and is necessary since average cardholder payments and losses could normally reduce outstanding

receivables to zero in one year or less, making the securities less attractive to investors and increasing securitization costs to the issuer.

During the amortization period, the trust allocates principal payments and losses to the investor and issuer based upon their pro-rata share of the outstanding balances. Some credit card securitizations have bullet amortization features, which make a single payment on the maturity date. Consequently, a credit card ABS results in amortization of outstanding balances back onto the issuer's books, which can occur in one year or less after amortization begins. However, issuers often repackage the receivables at maturity or during amortization into a new ABS. Management must carefully plan the association's securitizations to manage their effect on liquidity needs, asset size, and capital requirements as well as profitability.

Credit Enhancements

To attract investors, credit card ABS generally must obtain high investment quality ratings at origination. Therefore, issuers generally must include substantial credit enhancements with the ABS that will protect investors if the accounts fail to generate sufficient cash flows. Such enhancements include spread accounts⁴, letters of credit, cash collateral accounts, and subordination agreements. The level of credit enhancement an association requires to obtain a "AAA" rating compared with other issuers can provide insight as to the market's perception of the association's credit card operations and the riskiness of its portfolio. The credit enhancement provided by the association may constitute recourse to the association for regulatory capital purposes. (See [Appendix B](#) for interagency guidance relating to accrued interest receivable.) Management should continuously assess the performance of all transferred assets and evaluate the impact on retained interests through the ongoing estimate of future cash flows.

Recourse

Although the association removes sold receivables from its books for both financial and regulatory reporting purposes, it may still have to hold risk-based capital against amounts considered to reflect recourse to the seller. For securitizations, recourse typically involves the risk of loss that the seller retains in connection with the sale of the securitized loans to investors. The general rule is that for sales that qualify as sales under GAAP, the assets sold are not subject to risk-based capital requirements, provided the association meets both of the following conditions:

- Retains no risk of loss from the asset transferred.

⁴ A form of cash collateral account established from the monthly finance charges received from the underlying pool of receivables available to cover losses in any given month. If not needed, this excess spread generally reverts to the seller/servicer. Many trust agreements provide that if portfolio yield declines or losses increase, the monthly excess spread is captured in a spread account to provide future credit enhancement.

- Has no obligation to any party for the payment of principal or interest on the assets resulting from default, changes in market value after transfer, or any contractual relationship that could continue after final payment, default, or other termination of the assets transferred.

If a savings association retains recourse in a securitization, it must hold risk-based capital equal to the lesser of (a) the amount of recourse (if a low-level recourse option is appropriate), or (b) the risk-weighted capital requirement for the receivables as if they were still on the books. The amount of recourse for securitizations is generally measured by subordinations, guarantees, pledged collateral, spread accounts, or other association assets (including residual or other interest-only strips created under SFAS No. 140) that absorb losses prior to their recognition by the investors.

In addition, OTS restricts the amount of such residuals that may be includable in regulatory capital. You can find guidance for regulatory capital treatment of credit card securitizations in 12 CFR § 567.12.

Implicit Recourse

Recourse may exist without explicit contractual agreement, or if there is a contractual limit, where the association assumes risk of loss in amounts exceeding the limit. Implicit recourse is usually demonstrated by an association's actions subsequent to the sale. The following actions may be considered evidence of implicit recourse⁵:

- Providing voluntary support for securitization by selling assets into a trust at a discount from book value.
- Exchanging performing assets for nonperforming assets.
- Infusing additional cash into a spread account or other collateral account.
- Other actions to support an asset sale that result in an impairment of the association's capital.

Implicit recourse is usually demonstrated by an association's actions subsequent to the sale.

Such actions by the issuing savings association may represent recourse, even if such actions are not required of the issuer (and/or servicer) by trust documents. By taking these actions, OTS may require that other sales of receivables in a particular trust be fully risk weighted in calculating the association's regulatory capital requirement.

Other Considerations

In addition to the required regulatory risk-based capital treatment for recourse assets, be alert to the level and growth of spread accounts and other forms of recourse in relation to core and equity capital. This should include growth of recourse on existing securitizations, since spread account requirements

⁵ The above examples are illustrative and are not meant to be all-inclusive. Implicit recourse should be evaluated on a case-by-case basis.

for existing trusts will often increase when the performance of a trust declines. An unsafe condition can exist if the issuer has allocated an excessive amount of equity capital to recourse assets, and/or has large levels of unfunded spread account commitments outstanding during periods of weakening spreads. In addition, you should take into account the risk of loss relative to recourse arrangements when evaluating the adequacy of the ALLL.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

- § 1464(c)(1)(I) Credit Cards
- § 1464(c)(2)(D) Consumer Loans

Code of Federal Regulations (12 CFR)

Federal Reserve System

- Part 205 Electronic Funds Transfers Subject to Regulation E
- Part 226 Truth in Lending

Office of Thrift Supervision Regulations

- § 560.1 General
- § 560.3 Definitions
- § 560.30 Lending and Investment Powers Chart
- § 560.93 Lending Limitation
- § 560.170 Records for Lending
- § 563.170(e) Use of Data Processing Services
- Part 567 Capital

OTS Bulletins and CEO Memos

Regulatory and Thrift Bulletins

TB 51 Interagency Policy Statement on Prescreening

CEO Memos

No. 128 Revised Uniform Retail Credit and Account Management Policy (7/2000)

No. 104 Interagency Guidelines on Subprime Lending (3/1999)

No. 137 Expanded Guidance for Subprime Lending Programs (2/2001)

Interagency Guidance and Policy Statements

Account Management and Loss Allowance Guidance (January 2003) (See Appendix A)

Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations (December 2002) (See Appendix B)

Interagency Advisory on Credit Card-Related Merchant Activities (November 1993)

Uniform Retail Credit Classification and Account Management Policy (June 2000)

Interagency Policy Statement on Securitizations (December 1999)

Interagency Guidance on Subprime Lending (March 1999)

Interagency Policy Statement on Allowance for Loan and Lease Losses (December 1993)

Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (July 2001)

Financial Accounting Standards Board

Statement of Financial Accounting Standards (SFAS)

No. 140 Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities - a replacement of Statement No. 12