

RESCINDED

Outdated – See OCC 2020-11

For more recent information, refer to Comptroller's Handbook, "Retail Lending" and "Credit Card Lending."

AL 96-7

Subject: Credit Card Preapproved Solicitation

TO: Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel

PURPOSE

The purpose of this advisory letter is to alert national banks to risks associated with preapproved solicitations of credit cards. While some of the information presented can also apply to credit cards issued through other means such as a completed application, this Advisory Letter is focused on preapproved solicitation programs where a credit card issuer uses a list of potential customers from which it will make a firm offer of credit. The Advisory Letter discusses how proper risk assessment, controls, and planning can achieve the desired portfolio quality even in a period of adverse economic trends.

BACKGROUND

An increase in competition in the credit card business, rapid portfolio growth rates, and the availability of diverse credit card products have all changed the nature of credit card lending in recent years. Although accounting for only a relatively small percentage of total commercial bank assets, credit card loans have grown faster than any other type of consumer loans over the past 3 years. Recently there have been pronounced increases in the rates of default and delinquency for credit card loans.

Aggressive competition recently has pressured some banks to forgo customary and effective testing of new credit card products and preapproved solicitation campaigns in hopes of capturing a product market before a competitor. Despite the relatively small average loan size and high net interest margins in credit card lending, the default and delinquency trends are areas of concern for both bankers and regulators. Although this advisory discusses risks associated with preapproved solicitations for credit cards, the OCC cautions that similar risks may arise as banks use preapproved solicitations for other types of consumer lending such as home equity lines, small business and installment loans.

The OCC has identified certain weaknesses in some preapproved solicitation programs which can impair management's ability to promptly recognize and respond to existing and potential risks in their portfolios. These weaknesses are:

- o Lack of a comprehensive and independent risk management function.
- o Failure to adequately test and analyze potential markets for credit card solicitations.
- o Adverse selection of solicited customers resulting in a higher than expected overall risk profile of booked accounts.

- o Changes in underwriting criteria to increase card originations without proper testing and follow up or without analysis of prior experience.
- o Failure to adequately monitor the actual performance of new products compared with initial projections.

MANAGING RISKS IN CREDIT CARD LENDING

Identifying and Monitoring Risk

The risk management function, which may be located within the credit card area, promotes early and accurate identification of existing and potential problems, identifies the need for policy revisions, and provides management with the information it needs to respond promptly to changes. At a minimum, the risk management function should include responsibility for:

- o Performing product analyses to serve as the basis for underwriting, marketing, and portfolio management decisions.
- o Ensuring that marketing initiatives reflect levels of risk acceptable to management.
- o Managing and maintaining decision making systems which may include scoring systems.
- o Monitoring the performance of the portfolio, including the performance of specific products, marketing initiatives, analysis by origination (vintages) or other common factor, and other performance measures.
- o Analyzing delinquencies and losses in the portfolio and identifying causes of changes or trends.
- o Ensuring compliance with consumer protection laws and regulations.
- o Reporting appropriate risk management information to senior management and the board of directors.

Testing New Markets

Marketing is critical to the success or failure of a credit card operation. As appropriate, management should require that marketing staff:

- o Document each marketing initiative as appropriate.
- o Track and analyze successes and failures of previous product initiatives to help refine current and future offers.
- o Use sufficient modeling technology to segment and target appropriate markets.
- o Involve all applicable areas in the product planning process

to avoid subsequent problems due to inadequate systems and staffing.

- o Allow for adequate time to test market a product and monitor its credit quality before the product is fully implemented.
- o Report appropriate market testing information to senior management and the board of directors.

Targeting Creditworthy Customers

When a bank decides to offer a product to an identified market, it has in mind individuals that fit a certain customer profile. Adverse selection occurs when those responding to a product offering have, on average, different credit prospects than the targeted population. This may occur because the bank does not fully understand the market or is using noncurrent information in its analysis. Adverse selection may result in a product that is offered at a price that does not cover the potential risk for a given market as well as in greater-than-anticipated losses in response to a solicitation.

Management can minimize adverse selection by:

- o Reviewing product and underwriting guidelines to ensure consistency with the bank's long-term objectives and desired customer profile.
- o Setting pricing at levels that compensate for risk while remaining competitive in the market.
- o Conducting ongoing testing of risk-based price assumptions to determine if adverse selection has been controlled for future product offerings.
- o Using the prescreened list of borrowers promptly after receipt from the credit bureau to help ensure that credit is extended only to individuals meeting the specified standards.
- o Using a deadline for offer acceptance.

Properly Testing Solicitation Offers

A bank should gather appropriate data and devote sufficient resources to analyze the effect of changes in underwriting criteria on its credit card portfolio. Before lowering cutoff scores to increase credit card originations, a bank should test a sample of loans and analyze any prior experience, as appropriate, to determine whether the level of risk can be managed, appropriately priced, and is consistent with the bank's overall strategic objectives. The testing should:

- o Take place over an appropriate period of time before changes to underwriting standards are fully implemented.
- o Use appropriate systems and analytical tools to analyze

results.

- o Use performance data from recently acquired accounts for modeling and forecasting purposes.
- o Monitor warning signs of market deterioration, such as increases in personal bankruptcies, which may affect the accuracy of model assumptions.
- o Use analysts with experience in interpreting the models and forecasts selected.

Monitoring the Performance of Accounts Booked through Solicitations

Banks should perform regular analyses of new solicitations and products to compare actual performance with initial assumptions. Periodic reports and analyses on the performance of individual mailings should include the following information:

- o Data to measure portfolio quality of solicited accounts such as trends in delinquencies, bankruptcies, losses, behavior score distributions, and usage of the account.
- o Information on new business by initiative, source, and product.
- o Detail on credit quality indicators such as credit score distribution.
- o Portfolio statistics that can be tracked against comparable industry statistics.

RISKS IN CREDIT CARD LENDING

The preapproved solicitation activities discussed in this advisory letter expose a bank to credit, transaction, liquidity, strategic, reputation, and compliance risk. These risks are summarized below. A more detailed discussion of these risks and their management for credit card portfolios can be found in The Credit Card Lending section of the Comptroller's Handbook.

Credit Risk The risk to earnings or capital of an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed. Aggressive solicitation programs may increase the bank's credit risk if the resulting credit card accounts experience higher than projected delinquencies and losses.

Transaction Risk The risk to earnings or capital arising from problems with service or product delivery. An influx of new accounts from a solicitation may increase risk if a bank is unable to process the responses in an accurate or timely manner.

Liquidity Risk The risk to earnings or capital arising from a bank's inability to meet its obligations when they come due

without incurring unacceptable losses, including the inability to manage unplanned decreases or changes in funding sources. Higher risk assets, resulting from weaknesses in solicitation programs, may be difficult to securitize or sell and thus impact a bank's liquidity. Higher than anticipated delinquencies or losses in securitized pools may lead to market pressure on the bank to provide additional support to the pool. OCC Bulletin 96- 52 provides additional information on the risks associated with securitization programs.

Strategic Risk The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. Failure to adequately test a new market, analyze test results, and refine subsequent solicitation offers may result in unsuccessful marketing efforts or accounts that do not perform as anticipated.

Reputation Risk The risk to earnings or capital arising from negative public opinion. Poorly underwritten or performing receivables can affect a bank's reputation as a credit card issuer and as an underwriter of credit card securitizations. This creates a risk that future credit enhancements for securitizing credit card receivables may be more costly, reduced, or may not be available. If a bank's reputation as an underwriter is impaired, future accessibility to financial markets may be limited or cost more.

Compliance Risk The risk to earnings or capital arising from negative public opinion. Preapproved solicitations must comply with the FFIEC Interagency Policy Statement on Prescreening by Financial Institutions and the Fair Credit Reporting Act (see OCC BB 91-50). The Fair Credit Reporting Act is a consumer protection law which carries civil liability for negligent and willful noncompliance.

RISK MANAGEMENT OPTIONS

Inadequate management of risks in credit card lending can lead to portfolio deterioration and may have negative balance sheet and earnings implications.

Appropriate responses to portfolio deterioration may include:

- o Limiting solicitations.
- o Tightening credit standards.
- o Increasing the quality of analysis of potentially creditworthy borrowers by providing the credit bureau with comprehensive credit criteria to prescreen applicants.
- o Increasing the experience of staff assigned to conduct such analyses.
- o Ongoing monitoring of the payment performance of high-risk customers in existing accounts.

- o Tracking accounts experiencing adverse trends.
- o Strengthening collection efforts.

A bank with a deteriorating credit card portfolio may need to reassess its allowance for loan and lease loss (ALLL) allocations and its capital position. Greater inherent loss in the credit card portfolio may require additional ALLL allocations under GAAP. Increased overall risk caused by declining credit quality or weakening risk management practices may require the support of additional capital.

CONCLUSION

The OCC encourages each national bank involved in credit card lending to evaluate its business plan, current operations, and risk management control systems. Management should take appropriate action to limit its exposure to unwarranted risks.

ORIGINATING OFFICE

Questions concerning this advisory letter should be addressed to the Office of Chief National Bank Examiner at (202) 874-5350.

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