Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

Subject: ***Credit Card Lending*** *Description:* ***Account Management and Loss Allowance Guidance***

Purpose

Recent examinations of institutions engaging in credit card lending have disclosed a wide variety of account management, risk management, and loss allowance practices, a number of which were deemed inappropriate. This interagency guidance communicates the Agencies' expectations for prudent practices in these areas.

The Agencies recognize that some institutions may require time to implement changes in policies, practices, and systems in order to achieve full consistency with the guidance on credit card account management. Such institutions should work with their primary federal regulator to ensure implementation of needed changes as promptly as possible.

With respect to income recognition and loss allowance practices for credit card lending, the guidance reflects generally accepted accounting principles (GAAP), existing interagency policies on loss allowances, and current Call Report and Thrift Financial Report instructions.[1] The Agencies expect continued and ongoing compliance with GAAP and these reporting instructions.

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[1] Relevant GAAP guidance is provided in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, which provides the basic guidance on accounting for loss allowances for the collectibility of receivables. Additional GAAP guidance is within Chapter 7 of the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide *Banks and Savings Institutions.* Banking and thrift regulatory guidance is included in the Call Report and Thrift Financial Report instructions as well as in the July 6, 2001 Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions and the December 21, 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses.

Applicability of Guidance

The account management and loss allowance principles described herein are generally applicable to all institutions under the Agencies' supervision that offer credit card programs. The risk profile of the institution, the strength of internal controls (including internal audit and risk management), the quality of management reporting, and the adequacy of charge-off policies and loss allowance methodologies will be factored into the Agencies' assessment of the overall adequacy of these account management practices. Regulatory scrutiny and risk management expectations for certain practices, such as negative amortization of over-limit accounts, will be greater for higher risk portfolios and portfolio segments, including those that are subprime.

Wherever such practices are deemed inadequate or imprudent, regulators will require immediate corrective action.

Account Management, Risk Management, and Loss Allowance Practices

The Agencies expect institutions to fully test, analyze, and support their account management practices, including credit line management and pricing criteria, for prudence prior to broad implementation of those practices. Credit card lenders should review their practices and initiate changes where appropriate.

Credit Line Management

When assigning initial credit lines and/or significantly increasing existing credit lines, lenders should carefully consider the repayment capacity of borrowers. When inadequately analyzed and managed, practices such as multiple card strategies and liberal line-increase programs can increase the risk profile of a borrower quickly and result in rapid and significant portfolio deterioration.

Credit line assignments should be managed conservatively using proven credit criteria. The Agencies expect institutions to test, analyze, and document line-assignment and line-increase criteria prior to broad implementation. Support for credit line management should include documentation and analysis of decision factors such as repayment history, risk scores, behavior scores, or other relevant criteria.

Institutions can significantly increase credit exposure by offering customers additional cards, including store-specific private label cards and affinity relationship cards, without considering the entire relationship. In extreme cases, some institutions have granted additional cards to borrowers already experiencing payment problems on existing cards. The Agencies expect institutions that offer multiple credit lines to have sufficient internal controls and management information systems (MIS) to aggregate related exposures and analyze performance prior to offering additional credit lines.

Over-limit Practices

Account management practices that do not adequately control authorization and provide for timely repayment of over-limit amounts may significantly increase the credit risk profile of the portfolio. While prudent over-limit practices are important for all credit card accounts, they are especially important for subprime accounts, where liberal over-limit tolerances and inadequate repayment requirements can magnify the high risk exposure to the lending institution, and deficient reporting and loss allowance methodologies can understate the credit risk.

Over-limit practices at all institutions should be carefully managed and should focus on reasonable control and timely repayment of amounts that exceed established credit limits. Management information systems for all institutions should be sufficient to enable management to identify, measure, manage, and control the unique risks associated with over-limit accounts. Over-limit authorization on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls. The objective should be to ensure that the borrower remains within prudent established credit limits that increase the likelihood of responsible credit management.

Minimum Payment and Negative Amortization

Competitive pressures and a desire to preserve outstanding balances have led to a general easing of minimum payment requirements in recent years. New formulas that have the effect of further delaying principal repayment are gaining popularity in the industry. In many instances, the result has been liberal repayment programs that increase credit risk and mask portfolio quality. These problems are exacerbated when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and the outstanding balance continues to build ("negative amortization"). In these cases, the lender is recording uncollected income by capitalizing the unpaid finance charges and fees into the account balance owed by the customer. The pitfalls of negative amortization are magnified when subprime accounts are involved, and even more so when the condition is prolonged by programmatic, recurring over-limit fees and other charges that are primarily intended to increase recorded income for the lender rather than enhance the borrowers' performance or their access to credit.

The 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.

Workout and Forbearance Practices

Institutions should properly manage workout[2] programs. Areas of concern involve liberal repayment terms with extended amortizations, high charge-off rates, moving accounts from one workout program to another, multiple re-agings, and poor MIS to monitor program performance. Where workout programs are not managed properly, the Agencies will criticize management and require appropriate corrective action. Such actions may include adversely classifying entire segments of portfolios, placing loans on nonaccrual, increasing loss allowances to adequate levels, and accelerating charge-offs to appropriate time frames.

Temporary hardship programs that help borrowers overcome temporary financial difficulties are not considered workout programs for this guidance. Temporary hardship programs longer than a 12-month duration, including renewals, are considered workout programs.

Repayment Period - Repayment terms for accounts in workout programs vary widely among credit card issuers. Practices range from programs designed to maximize collection of balances owed to programs apparently designed to maximize income recognition and defer losses. Some institutions' programs have not reduced interest rates sufficiently to facilitate timely repayment and assist borrowers in extinguishing indebtedness. In many cases, reduced minimum payment requirements in combination with continued charging of fees and finance charges have extended repayment periods well beyond reasonable time frames.

Workout programs should be designed to maximize principal reduction. Workout programs should generally strive to have borrowers repay credit card debt within 60 months. Repayment terms for workout programs should be consistent with these time frames, with exceptions clearly documented and supported by compelling evidence that less conservative terms and conditions are warranted. To meet these time frames, institutions may need to substantially reduce or eliminate interest rates and fees so that more of the payment is applied to reduce principal.

Settlements - Institutions sometimes negotiate settlement agreements with borrowers who are unable to service their unsecured open-end credit. In a settlement arrangement, the institution forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over a several month period. Institutions' charge-off practices vary widely with regard to settlements.

Institutions should ensure that they establish and maintain adequate loss allowances for credit card accounts subject to settlement arrangements. In addition, the FFIEC Uniform Retail Credit Classification and Account Management Policy states that "actual credit losses on individual retail loans should be recorded when the institution becomes aware of the loss." In general, the amount of debt forgiven in a settlement arrangement should be classified loss and charged off

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[2] For purposes of this guidance, a workout is a former open-end credit card account upon which credit availability is closed, and the balance owed is placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization/liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with its original terms, but shows the willingness and ability to repay the loan in accordance with its modified terms and conditions.

immediately. However, a number of issues may make immediate charge-off impractical. In such cases, institutions may treat amounts forgiven in settlement arrangements as specific allowances.[3] Upon receipt of the final settlement payment, deficiency balances should be charged off within 30 days.

Income Recognition and Loss Allowance Practices

Most institutions use historical net charge-off rates, based on migration analysis of the roll rates[4] to charge-off, as the starting point for determining appropriate loss allowances. Institutions then typically adjust the historical charge-offs for current trends and conditions and other factors. Recent examinations of credit card lenders have revealed a variety of income recognition and loss allowance practices. Such practices have resulted in inconsistent estimates of incurred losses and, accordingly, the inconsistent reporting of loss allowances.

Accrued Interest and Fees[5] **-** Institutions should evaluate the collectibility of accrued interest and fees on credit card accounts because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual based on delinquency status, the Agencies expect all institutions to employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. Institutions must account for the owned portion of accrued interest and fees, including related estimated losses, separately from the retained interest in accrued interest and fees from credit card receivables that have been securitized.

Loan Loss Allowances - The allowance for loan and lease losses (ALLL) should be adequate to absorb credit losses that are probable and estimable on all loans. While some institutions provide for an ALLL on all loans, others only provide for an ALLL on loans that are delinquent. Typically, this practice results in an inadequate ALLL. Institutions should ensure that their loan impairment analysis and ALLL methodology, including the analysis of roll rates, consider the loss inherent in both delinquent and non-delinquent loans.

Allowances for Over-limit Accounts - Institutions' allowance methodologies do not always fully recognize the loss inherent in over-limit portfolio segments. For example, if borrowers were required to pay over-limit and other fees, in addition to the minimum monthly payment amount each month, roll rates and estimated losses may be higher than indicated in the overall

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[3] For regulatory reporting purposes, banks should report the creation of a specific allowance as a charge-off in Schedule RI-B of the Reports of Condition and Income (Call Report). Savings associations should report these specific allowances, along with other specific allowances, on Schedule VA in the Thrift Financial Report (TFR). Loans to which specific allowances apply should be reported net of specific allowances in the Call Report and TFR.

[4] Roll rate is the percentage of balances, or accounts, that move from one delinquency stage to the next delinquency stage.

[5] AICPA Statement of Position 01-6 *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others* provides guidance on accounting for delinquency fees.

portfolio migration analysis. Accordingly, institutions should ensure that their allowance methodology addresses the incremental losses that may be inherent on over-limit accounts.

Allowances for Workout Programs - Some institutions' allowances do not appropriately provide for the inherent probable loss in workout programs, particularly where repayment periods are liberal with little progress on reducing principal. The success of workout programs varies widely by program and among institutions.

Accounts in workout programs should be segregated for performance measurement, impairment analysis, and monitoring purposes. Where multiple workout programs with different performance characteristics exist, each program should be tracked separately. Adequate allowances should be established and maintained for each program. Generally, the allowance allocation should equal the estimated loss in each program based on historical experience as adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, volume and mix, terms and conditions of each program, and collections.

Recovery Practices - After a loan is charged off, institutions must properly report any subsequent collections on the loan.[6] Typically, some or all of such collections are reported as recoveries to the allowance for loan and lease losses. Recent examinations have revealed that, in some instances, the total amount credited to the ALLL as recoveries on an individual loan (which may have included principal, interest, and fees) exceeded the amount previously charged off against the ALLL on that loan (which may have been limited to principal). Such a practice understates an institution's net charge-off experience, which is an important indicator of the credit quality and performance of an institution's portfolio.

Consistent with regulatory reporting instructions and prevalent industry practice, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

Policy Exceptions

The Agencies recognize that in well-managed programs limited exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy may be warranted. The basis for granting exceptions to the Policy should be identified and described in the institution's policies and procedures. Such policies and procedures should address the types of exceptions allowed and the circumstances for permitting them. The volume of accounts granted exceptions should be small and well controlled, and the performance of accounts granted exceptions should be closely monitored. Examiners will evaluate whether an institution uses exceptions prudently. When exceptions are not used prudently, are not well managed, result in improper reporting, or mask delinquencies and losses, management will be criticized and corrective action will be required.

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[6] AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.