
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.

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

The Agencies expect institutions to manage credit lines conservatively, using proven credit criteria and a sound process that includes testing, analysis, and controls. All credit line assignments should be preceded by evaluation and documentation of the borrower's creditworthiness as supported by repayment history, risk scores, behavior scores, or judgmental review. The Agencies expect institutions to fully test, analyze, and justify line-assignment and line-increase criteria prior to broad implementation.

Institutions can significantly increase customers' credit exposures by offering them additional cards, including store-specific private label cards and affinity relationship cards. Institutions should fully consider the amount and performance of existing lines in new account underwriting, account management, and collection decisions, in order to ensure that borrowers are not extended additional credit beyond their ability to repay.

Without adequate controls, some borrowers can be extended credit beyond their ability to repay. For example, 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 authorizations, provide for timely repayment of over-limit amounts, and prevent negative amortization may significantly increase the credit risk profile of the portfolio. While prudent over-limit practices are important for all institutions, they are especially important for subprime lenders, where liberal over-limit tolerances, inadequate repayment requirements, and deficient reporting and loss allowance methodologies can magnify the high credit risk exposure of those institutions.

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 identify, measure, manage, and control the unique risks associated with over-limit accounts. The policies of subprime lenders should prohibit or severely restrict over-limit authorization on open-end subprime accounts. The objective should be to ensure that the borrower remains within prudent, established credit limits that increase the likelihood of responsible credit management.

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Negative amortization occurs when the required minimum payment is insufficient to cover fees and finance charges, including over-limit fees, assessed in the current billing cycle. The Agencies generally consider allowing negative amortization for over-limit subprime accounts to be an imprudent practice.

Where over-limits are authorized for subprime accounts, policies and practices should be structured to limit negative amortization and promptly collect all over-limit amounts. Approaches to accomplish these objectives on over-limit subprime accounts include, but are not limited to, discontinuing over-limit fees after the initial cycle, requiring a minimum payment amount that is at least sufficient to fully cover all interest and fees (e.g., over-limit and late payment) assessed on over-limit accounts in the current billing cycle, and requiring the minimum payment to include the full payment of the entire over-limit amount.

Workout and Forbearance Practices

Institutions should properly manage workout¹ 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 classifying entire segments of portfolios, placing loans on nonaccrual, increasing loss allowances to adequate levels, and accelerating charge-offs to appropriate time frames.

Repayment Period - Repayment terms for revolving credit 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. Debt management plans developed by consumer credit counseling services generally strive to have borrowers repay credit card debt within 48 months. Repayment terms for workout programs should be generally 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.

¹ 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.

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 any settlement arrangement should be classified loss and charged off immediately. However, a number of issues may make immediate charge-off impractical. In such cases, institutions may treat the portion of the allowance equal to the amounts forgiven in settlement arrangements as specific allowances.² Remaining settlement balances should be charged off immediately if there is any doubt as to the customer's willingness or ability to repay the settlement amount in a timely manner.

Income Recognition and Loss Allowance Practices

Most institutions use historical net charge-off rates, based on migration analysis of the roll rates³ 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 - 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 collectable. 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 uncollectable fees and finance charges or placing delinquent and impaired receivables on nonaccrual status.

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 ALLL methodology, including the analysis of roll rates, considers both delinquent and current loans.

² 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.

³ Roll rate is the percentage of balances, or accounts, that move from one delinquency stage to the next delinquency stage.

Allowances for Over-limit Accounts - Institutions' allowance methodologies do not always 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 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 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. Typically, some or all of such collections are reported as a recovery to the allowance for loan and lease losses. Recent examinations have revealed that, in some instances, the amount credited to the ALLL as a recovery (which may have included principal, interest, and fees) exceeds 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 generally accepted accounting principles, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that an amount reported as a recovery on a loan is limited to the amount previously charged off against the ALLL on that loan.

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 permitted 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 are being used to mask delinquencies and losses, management will be criticized and corrective action will be required.