



Credit Card Lending

Summary: This bulletin provides new Examination Handbook Section 218, Credit Card Lending. It replaces the existing Thrift Activities Handbook Section 218.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Credit Policy division of the OTS, Washington, DC. You may access this bulletin and the Handbook Section at our web site: www.ots.treas.gov.

Regulatory Bulletin 37-16

SUMMARY OF CHANGES

This handbook section addresses credit card operations. We substantially revised and updated this section to provide OTS examiners and savings association personnel with guidance on credit card operations, to incorporate interagency guidance related to credit card lending activities, and to highlight aspects of credit card lending that may present a supervisory concern. The main topics of this handbook section are discussed below.

218 Credit Card Lending

Introduction: Provides an overview of the credit card business and the Home Owner's Loan Act authority to invest in credit card receivables; credit card risks and controls; different product lines; subprime credit card lending; and the various roles of savings associations in the credit card business.

Credit Card Operations: Discusses the entire spectrum of credit card operations including underwriting, account acquisition practices (including credit scoring models and test marketing strategies), account management activities, collections, workouts, and fraud control. This section also covers consumer considerations (such as unfair or deceptive acts and the new Bankruptcy Act's amendments to the Truth in Lending Act), allowance for loan losses considerations, and profitability analysis.

Securitization: Provides information on the securitization and servicing of pools of credit card receivables, including trust structure, credit enhancements, and recourse.

Regulatory Bulletin 37-16

Appendices: A: Interagency Account Management and Loss Allowance Guidance; B: Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations.





The remainder of the section includes examination objectives, examination procedures, and a credit card lending questionnaire.



—*Scott M. Albinson*
Managing Director
Examinations, Supervision, and Consumer Protection

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.

L I N K S	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
 Program	accounts without a statutory percentage of asset limitation. While many lenders
 Questionnaire	consider credit card accounts to individuals as consumer loans, HOLA's credit
 Appendix A	card lending authorization is separate from and in addition to the investment
 Appendix B	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.

Scoring models take the available credit information in various combinations, weight it according to its importance, and arrive at a final score.

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

Credit Card Lending Program

EXAMINATION OBJECTIVES

To determine if the policies, procedures, and controls regarding credit cards adequately ensure safety and soundness and compliance with laws and regulations.

To determine if officers and employees are qualified and performing their duties in a manner that ensures safety and soundness and is in conformance with policies and procedures.

To determine if financial records and management reports provide accurate and necessary information to management and directors.

To determine the adequacy of the audit and internal loan review function in this area.

To evaluate the credit card portfolio for credit quality and overall risk.

To determine if any recourse, either contractual or implicit, exists for any sold or securitized accounts.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note violations of laws or regulations.

EXAMINATION PROCEDURES

Perform the following procedures as appropriate depending on the size, complexity, and risk profile of the association's credit card operations. Not all procedures are necessary for each examination. You should determine which procedures are necessary during the scoping process.

Execute the following examination procedures in conjunction with [Handbook Section 201, Lending Overview](#), review. When an association has multiple loan departments (e.g., segregated by lending type(s)), you should arrive at a conclusion about the individual lending operations and an overall evaluation of the lending function and the quality of the loan portfolio. The Examiner-in-Charge (EIC) or assisting examiner responsible for Asset Quality should avoid duplication of effort by ensuring an exchange of information and results from examiners responsible for the different Asset Quality sections.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Credit Card Lending Program

WKP. REF.

LEVEL I

WKP. REF.

This section expands on the general lending policies described in [Handbook Section 201 Overview](#), and [Section 217, Consumer Lending](#) to include additional guidelines for Credit Card Lending and the use of Credit Scoring Models.

1. Participate in the Level I reviews of Sections [201](#) and [217](#), or discuss the findings with the EIC. The review should focus on whether the association's loan policies and procedures address the different types of credit cards offered and how they are solicited. It should also assess whether the underwriting guidelines, including lending limits and documentation requirements, are appropriate.

2. Review the PERK information and the scoping material related to this area including the PERK credit card operation alert letter, if applicable.

3. Determine whether the association has corrected deficiencies mentioned in prior examination reports and audit reports.

4. In conjunction with the EIC or examiner(s) performing the board and management report reviews under Sections [260](#), [310](#), and [330](#), ascertain if any problems or concerns regarding credit card lending were noted.

5. Review management information systems (MIS) delinquency and performance reports as well as board reports relating to credit card operations. This may have already been performed in connection with [Handbook Section 201](#). If so, coordinate with the examiner who performed that work. Determine if MIS and board reports are adequate and accurate. Use performance information to focus your review on higher risk or problem areas.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Credit Card Lending Program

WKP. REF.

6. Using an appropriate sampling technique, select accounts for review. (See [Handbook Section 209, Sampling](#).) For associations relying on automated credit decisions, the review should include a check for compliance with underwriting policies by focusing on exception reports (accounts approved by individuals after rejection by the automated process).

7. Determine whether the association is adhering to the *Interagency Account Management and Loss Allowance Guidance* with respect to credit line management, over-limit practices, workout and forbearance practices, income recognition, loss allowance practices, and policy exceptions. Determine whether the credit card portfolio is experiencing any overall negative amortization. (See [Appendix A](#).)

8. Ensure that the required monthly minimum payment amount is sufficient to ensure at least a one percent principle balance reduction.

9. Determine if the association is properly classifying its credit card accounts in accordance with the *Uniform Retail Credit Classification and Account Management Policy*.

10. Assess the adequacy of any re-aging programs.

11. Complete the [Credit Card Lending Questionnaire](#) or, if completed by management, verify for accuracy.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Credit Card Lending Program

WKP. REF.

12. Determine whether the association has established adequate allowance for loan and lease losses for the credit card portfolio.
-

13. Coordinate with the examiner reviewing the compliance management function to ensure that the credit card lending area is adequately covered within the scope of compliance management oversight, and that there are no material violations of consumer lending laws that could impact the risk profile of the credit card portfolio.
-

14. If you find problems, deficiencies, or excessive risk in the performance of the aforementioned procedures, discuss the preliminary findings with the EIC or examiner(s) assigned to the asset quality area and expand the scope accordingly. Expanded procedures need to be sufficient to both verify and support the preliminary findings or indicate that the findings do not appear to be an area of concern.
-

15. Reconcile the credit card portfolios to the trial balance and Thrift Financial Report.
-

16. Review the validity of the accounting for residual interests in the securitization of credit card receivables and the effect of any recourse on the thrift.
-

17. Verify level of concentration risk and the effect on capital.
-

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Credit Card Lending Program

WKP. REF.

18. Determine the overall level of credit risk in the portfolio by reviewing the association's internal or external credit score.
-

19. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
-

LEVEL II

1. Expand sample of loans in portfolios where you note significant risks and/or deficiencies. Place specific emphasis on re-aged accounts, over-limit approvals, and declinations or approval of applicants per override.
-

2. Expand the analysis of the internal loan review process.
-

3. Expand the review of the scope and depth of work performed by internal and external auditors.
-

4. Expand the review of the internal rating system and allowances for loan losses.
-

5. Expand the analysis of the account acquisition and underwriting process.
-

6. Review the organizational structure of the credit card area, including MIS, and the qualifications, capabilities, and expertise of its principal officers.
-

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Credit Card Lending Program

WKP. REF.

7. Summarize findings (including the reasons for expansion of scope), obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations.

8. Ensure that your review meets the Objectives of this Handbook Section and [Section 201](#). State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Credit Card Lending Questionnaire

Yes No

If the savings association acts only as the agent (refer to [Handbook Section 218](#)) for a credit grantor, it is not necessary to use the questionnaire.

Credit Card Policies and Procedures

1. Has the board of directors adopted written credit card policies that establish:
 - The type of activity, acceptable return, acceptable level of risk, and level of commitment of resources and assets?
 - Detailed procedures for reviewing credit card applications?
 - Standards for determining credit lines?
 - Minimum standards for documentation?
 - Collection procedures?
2. Do the board and management review credit card policies at least annually?

Underwriting Standards

1. Do audit and/or internal loan review staff test compliance with underwriting standards?
2. Are underwriting standards periodically reviewed and revised?
3. Are data from applications tested for input accuracy to the account processing system?
If so, what is the sample size and frequency of the test?
[Click&type]
4. Does an independent person periodically review line of credit increases to determine compliance with the association's policies and procedures?
5. Does an independent person periodically review credit lines for appropriateness of amount?

Credit Card Lending Questionnaire

	Yes	No
6. Are procedures in effect to review credit lines when the association becomes aware of a change in financial status or creditworthiness of a cardholder?	<input type="checkbox"/>	<input type="checkbox"/>
7. Does the association have procedures covering the establishment and periodic review of employee accounts?	<input type="checkbox"/>	<input type="checkbox"/>
8. Is the information on fraud claims reviewed to determine whether: an employee was involved; a breakdown in the savings association's control of issued cards occurred; or the card may have been taken before it left the association?	<input type="checkbox"/>	<input type="checkbox"/>
9. Is an officer required to sign off on the conclusion of a fraud investigation?	<input type="checkbox"/>	<input type="checkbox"/>
10. Does the credit card operation prepare a budget by: function (e.g., collections, application processing), program (e.g., secured card, private label), and overall operations?	<input type="checkbox"/>	<input type="checkbox"/>
11. Are actual results compared to budget at least quarterly?	<input type="checkbox"/>	<input type="checkbox"/>
12. Are significant trends and deviations adequately explained in the financial review process?	<input type="checkbox"/>	<input type="checkbox"/>
13. If assets are securitized, do asset securitizations receive appropriate approval?	<input type="checkbox"/>	<input type="checkbox"/>
14. Does the association have appropriate collection programs for securitized loans?	<input type="checkbox"/>	<input type="checkbox"/>
15. Does management have a plan to ensure adequate funding for maturing securitizations and in the event of early amortization?	<input type="checkbox"/>	<input type="checkbox"/>

Credit Card Records

- | | | |
|--|--------------------------|--------------------------|
| 1. Are preparation and posting of subsidiary credit card records performed or reviewed by persons who do not also: | | |
| • Issue official checks and drafts? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Handle cash and checks? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are subsidiary credit card records reconciled daily to appropriate general ledger accounts? | <input type="checkbox"/> | <input type="checkbox"/> |

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Credit Card Lending Questionnaire

		Yes	No
3.	Are reconciling items investigated by persons who do not also originate entries or handle cash and checks?	<input type="checkbox"/>	<input type="checkbox"/>
4.	Are delinquent account past-due notices handled only by persons who do not also handle cash and checks?	<input type="checkbox"/>	<input type="checkbox"/>
5.	Are inquiries about loan balance received and investigated by persons who do not also handle cash and checks?	<input type="checkbox"/>	<input type="checkbox"/>
6.	Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not handle cash and checks?	<input type="checkbox"/>	<input type="checkbox"/>
7.	Does the association maintain a daily record summarizing transaction details, such as charges, cash advances, payments received, and interest and fees collected to support applicable general ledger account entries?	<input type="checkbox"/>	<input type="checkbox"/>
8.	Are two authorized signatures required to effect a status change regarding individual customer accounts?	<input type="checkbox"/>	<input type="checkbox"/>
9.	Are file maintenance changes reviewed and compared with approved change requests?	<input type="checkbox"/>	<input type="checkbox"/>
10.	Is an exception report produced and reviewed by management that encompasses extensions, renewals, overlines, or other factors that would result in a change in customer account status?	<input type="checkbox"/>	<input type="checkbox"/>
11.	Is an overdue accounts report generated for each billing cycle?	<input type="checkbox"/>	<input type="checkbox"/>

Loan Interest and Merchant Discount

1.	Are the preparation and posting of interest and fees performed or reviewed by persons who do not also:		
	• Issue official checks and drafts?	<input type="checkbox"/>	<input type="checkbox"/>
	• Handle cash and checks?	<input type="checkbox"/>	<input type="checkbox"/>
2.	Are sales drafts posted promptly to customer account?	<input type="checkbox"/>	<input type="checkbox"/>

Credit Card Lending Questionnaire

	Yes	No
3. Are merchants carefully screened with credit underwriting criteria?	<input type="checkbox"/>	<input type="checkbox"/>
4. Are items missing from a merchant's remittance of sales charged back to the merchant, or otherwise adjusted satisfactorily?	<input type="checkbox"/>	<input type="checkbox"/>
5. Are merchants' accounts monitored for number and frequency of missing, rejected, or otherwise unsatisfactory items?	<input type="checkbox"/>	<input type="checkbox"/>
6. Are merchants' accounts subject to holding for collected balances?	<input type="checkbox"/>	<input type="checkbox"/>
7. Are all holdover items cleared daily?	<input type="checkbox"/>	<input type="checkbox"/>
8. Are merchants' accounts monitored for unusual volume fluctuations?	<input type="checkbox"/>	<input type="checkbox"/>
9. Are all rejected items cleared the following day?	<input type="checkbox"/>	<input type="checkbox"/>
10. Is a review of rejected drafts and payments made by someone independent of the processing clerks?	<input type="checkbox"/>	<input type="checkbox"/>
11. Is incoming mail maintained under dual control?	<input type="checkbox"/>	<input type="checkbox"/>
12. Are service charge policies universally applied to accounts?	<input type="checkbox"/>	<input type="checkbox"/>
13. Does an officer review and approve all internally prepared entries affecting customer account records?	<input type="checkbox"/>	<input type="checkbox"/>
14. Are records of those entries maintained and reviewed?	<input type="checkbox"/>	<input type="checkbox"/>
15. Is there a separate control account for accounting for merchants' accounts payable?	<input type="checkbox"/>	<input type="checkbox"/>
16. Are the merchants' accounts paid on a regular basis?	<input type="checkbox"/>	<input type="checkbox"/>
17. Does someone other than the person who made the original computations or who prepared the original input data periodically check merchants' discount computations?	<input type="checkbox"/>	<input type="checkbox"/>

Credit Card Lending Questionnaire

Yes No

Card Issuance and Control

- | | | | |
|-----|--|--------------------------|--------------------------|
| 1. | Does the association balance daily the records of issued cards to the electronic data processing report total of new and reissued cards? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. | Does someone independent of the embossing unit reconcile the daily record of issued, spoiled, and on-hand cards at the embossing unit? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. | Is the association certain that the card manufacturer is financially responsible and reputable? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. | Is the card manufacturer required to provide adequate security controls over cards during all phases of processing and shipping? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. | Are incoming shipments of cards: | | |
| | • Examined for tampering? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Placed in joint custody? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Verified to shipping documents under joint custody? | <input type="checkbox"/> | <input type="checkbox"/> |
| | • Properly entered on the record of cards received? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. | Are unissued cards kept under effective dual control and accounted for in each of the various steps in encoding, embossing, stuffing, and mailing? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. | Are cards embossed for issuance only upon receipt of properly authorized written instructions? | <input type="checkbox"/> | <input type="checkbox"/> |
| 8. | Are adequate controls maintained over any cards that were embossed and not issued to customers? | <input type="checkbox"/> | <input type="checkbox"/> |
| 9. | Is the embossing area restricted to prevent unauthorized access? | <input type="checkbox"/> | <input type="checkbox"/> |
| 10. | Does the embossing machine have a key controlled counter? | <input type="checkbox"/> | <input type="checkbox"/> |
| 11. | If so, is it locked when not in use? | <input type="checkbox"/> | <input type="checkbox"/> |

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Credit Card Lending Questionnaire

	Yes	No
12. Are there adequate controls over the use of encoding equipment?	<input type="checkbox"/>	<input type="checkbox"/>
13. Is locked storage space provided for cards during employee meals and coffee breaks?	<input type="checkbox"/>	<input type="checkbox"/>
14. Are cards spoiled during the embossing process destroyed under dual control?	<input type="checkbox"/>	<input type="checkbox"/>
15. Are both employees present during destruction required to sign the destruction register?	<input type="checkbox"/>	<input type="checkbox"/>
16. Are at least two persons present while cards are being processed?	<input type="checkbox"/>	<input type="checkbox"/>
17. Do employees embossing cards maintain a record of:		
• Cards received from master supply?	<input type="checkbox"/>	<input type="checkbox"/>
• Cards embossed on a daily basis?	<input type="checkbox"/>	<input type="checkbox"/>
• Cards spoiled and subsequently destroyed?	<input type="checkbox"/>	<input type="checkbox"/>
• Cards returned to master supply?	<input type="checkbox"/>	<input type="checkbox"/>
18. Is certification of blank cards made at least monthly by someone who is not involved in card handling?	<input type="checkbox"/>	<input type="checkbox"/>
19. Is the reserve supply of blank cards under dual custody?	<input type="checkbox"/>	<input type="checkbox"/>
20. Are cards placed in envelopes for mailing under joint custody and checked to the issuance register at the same time?	<input type="checkbox"/>	<input type="checkbox"/>
21. Are cards maintained in joint custody before, during, and after mail processing until they have been delivered to the U.S. Post Office?	<input type="checkbox"/>	<input type="checkbox"/>
22. Are cards sent by no forwarding mail?	<input type="checkbox"/>	<input type="checkbox"/>
23. Is control established over cards returned from the Post Office as undeliverable so that:		
• The mail is opened under joint custody?	<input type="checkbox"/>	<input type="checkbox"/>

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Credit Card Lending Questionnaire

	Yes	No
• The returned cards are placed under dual control?	<input type="checkbox"/>	<input type="checkbox"/>
• Cards for which a correct address can be found are immediately remailed?	<input type="checkbox"/>	<input type="checkbox"/>
• Cards for which no address can be found are destroyed?	<input type="checkbox"/>	<input type="checkbox"/>
• The same controls are also established on cards returned by the customer for cancellation?	<input type="checkbox"/>	<input type="checkbox"/>
• An expiration date is printed on each card?	<input type="checkbox"/>	<input type="checkbox"/>
• A system is established to retrieve cards if a problem develops?	<input type="checkbox"/>	<input type="checkbox"/>
24. Are test or demonstration cards adequately controlled?	<input type="checkbox"/>	<input type="checkbox"/>
25. If the association issues cards at more than one location (such as at branches), does it have card control procedures for these locations?	<input type="checkbox"/>	<input type="checkbox"/>
26. If vendors produce the cards, does legal counsel review the contracts for services?	<input type="checkbox"/>	<input type="checkbox"/>
27. Are cards mailed to customers in envelopes with a return address that does not identify the association's name or usual place or business?	<input type="checkbox"/>	<input type="checkbox"/>
28. Are returned cards controlled and accounted for by individuals other than those with card issuer or system operations responsibilities?	<input type="checkbox"/>	<input type="checkbox"/>
29. Is it against policy for the association to mail unsolicited cards?	<input type="checkbox"/>	<input type="checkbox"/>
30. Are cards that were left inadvertently or captured at Remote Service Unit (RSU) locations properly controlled?	<input type="checkbox"/>	<input type="checkbox"/>
31. Are plastic card and personal identification numbers (PINs) always mailed separately and on different dates?	<input type="checkbox"/>	<input type="checkbox"/>
32. After the card is issued, is there a follow-up mailing to inquire if the customer received the card and the PIN?	<input type="checkbox"/>	<input type="checkbox"/>

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Credit Card Lending Questionnaire

- | | Yes | No |
|---|--------------------------|--------------------------|
| 33. Are "hot" card lists and expiration dates used to limit the period of exposure when a card is lost, stolen, or otherwise misused? | <input type="checkbox"/> | <input type="checkbox"/> |

Personal Security Identifiers (PSIs)

- | | | |
|--|--------------------------|--------------------------|
| 1. Are PSIs or Personal Identification Number (PINs) controlled with system-access controls and printed only in line envelopes? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. In the event a customer's PIN is lost or forgotten: | | |
| • Are there adequate control procedures for old PIN cancellation and new PIN issuance? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Is there accountability on the persons initiating such transactions? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Is the PIN encrypted or disguised when: | | |
| • Transmitted over public access telephone lines? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Stored in computer files? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Is all documentation relating to encryption, decryption, and PIN generation properly secured? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. In the unlikely event that management insists on having access to both customer account numbers and PINs, have adequate compensating controls been implemented? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. If PINs corresponding account numbers appear in a format where they could be matched, are controls maintained to prevent compromising situations? | <input type="checkbox"/> | <input type="checkbox"/> |

Credit Card Lending Questionnaire

Yes No

Application Review

Review the following control procedures for each type of RSU application, such as: ATM, POS, telephone bill paying, transfers, and debit cards.

Interchange of Terminal Sharing

- | | | |
|--|--------------------------|--------------------------|
| 1. If terminals are shared, does the written agreement among associations clearly identify the rights and responsibilities of all parties, including installation, maintenance, and training of employees and customers? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Does the agreement cover responsibilities in the event of equipment failure? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Has the association established data storage and forward procedures to update records after a system pause in operations? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Can the association identify the terminal or communications device from which data are entering? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Is there a daily settlement procedure for each shared device? | <input type="checkbox"/> | <input type="checkbox"/> |

Operational Controls

- | | | |
|---|--------------------------|--------------------------|
| 1. Are transactions promptly posted to customer accounts? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are "hot" card and suspect lists properly updated and distributed? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Do exception reports meet the needs of management, user, and audit departments? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Do exception reports receive appropriate daily review? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Are customer names and addresses protected from unauthorized changes? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Are procedures manuals adequate to ensure continuity in the maintenance of control procedures? | <input type="checkbox"/> | <input type="checkbox"/> |

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

**Credit Card Lending
Questionnaire**

Comments

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

**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
Date: January 8, 2003

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.

Contents

Purpose..... 1
 Applicability of Guidance 2
 Account Management, Risk Management, and Loss Allowance Practices 2
 Credit Line Management..... 2
 Over-limit Practices..... 3
 Minimum Payment and Negative Amortization..... 3
 Workout and Forbearance Practices 4
 Income Recognition and Loss Allowance Practices..... 5
 Policy Exceptions 6

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 workout² 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.

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.

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 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 rates⁴ 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.

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.

Accrued Interest and Fees⁵ - 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 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.

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.

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

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.

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

December 4, 2002

**Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable
Related to Credit Card Securitizations**

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are issuing this advisory to clarify the appropriate accounting treatment for banks and thrift institutions (institutions) that securitize credit card receivables and record an asset commonly referred to as Accrued Interest Receivable (AIR).¹ The guidance contained in this issuance is consistent with generally accepted accounting principles (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.² The agencies consulted with the staffs of the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) in developing this guidance.

The AIR asset represents the transferor’s (seller’s) subordinated retained interest in cash flows that are initially allocated to the investors’ portion of a credit card securitization. Prior to the securitization transaction, the transferor directly owns a pool of credit card receivables, including the right to receive all of the accrued fees and finance charges on those receivables. However, through the securitization process, the seller’s right to the cash flows from the collection of the accrued fees and finance charges generally is subordinated to the rights of the other beneficial interest holders.

This guidance clarifies that, when the seller’s right to the AIR cash flows is subordinated as a result of a credit card securitization, the seller generally should include the AIR as one of the financial components in the initial accounting for the sale of credit card receivables in a securitization and in computing the gain or loss on sale. As a result, after a securitization, the allocated carrying amount of the AIR will typically be lower than its face amount. Consistent with the agencies’ May 17, 2002, regulatory capital guidance, the seller should treat this asset as a subordinated retained interest (beneficial interest). In addition, an institution

¹ 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.

² These regulatory reports include the bank Consolidated Reports of Condition and Income (Call Report), and the Thrift Financial Report (TFR).

should account for the AIR separately from loans, and report it in “Other Assets” in the institution’s regulatory reports.

Institutions should ensure that they are following the accounting guidance described in this advisory. If an institution has not followed this accounting approach in the past, it should adopt it in the next regulatory report that it files and in all subsequent reports. Institutions that have been properly accounting for the AIR are expected to continue to do so.

Background

Creation of the Accrued Interest Receivable Asset

In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal, finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale under FAS 140, the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet.

Many credit card securitizers recognize accrued fee and finance charge income on the investors’ portion of the transferred credit card receivables (the AIR) as a receivable due from customers, even though the right to receive this income, if and when collected, has been transferred to the trust. An AIR asset reflecting the amount due from the trust is typically reported throughout the life of the securitization because the seller continually transfers new receivables to the trust to replace receivables held by the trust that have been repaid or written off.

Subordination of the Accrued Interest Receivable Asset

The accounting for the securitization of credit card receivables depends upon the terms and requirements of the specific securitization structure. Although some terms and requirements of individual structures vary, most credit card securitizations provide similar credit enhancements to investors and should be accounted for in a similar manner.³ Typically, the seller transfers receivables to the trust consisting of loan principal (credit card purchases and cash advances) as well as accrued fees and finance charges. The AIR typically consists of the seller’s retained interest in the investor’s portion of (1) the accrued fees and finance charges that have been billed to customer accounts, but have not yet been collected (“billed but uncollected”), and (2) the right

³ The legal documentation and structure of the securitization transaction set forth the specific rights to trust assets and cash flows purchased by the investor and retained by the transferor. In some securitizations, the investor maintains a pro rata share of all trust assets, whether principal, finance charges or fees. In other securitizations, the transferor does not legally sell the accrued fees and finance charges to the trust, but is obligated to remit cash collections of these fees and finance charges to the trust. In either case, the trust will generally have a senior claim on the accrued interest receivable. However, the structure of the transaction may affect how the retained interests (including subordinated retained interests) are measured for accounting (and regulatory capital) purposes. Accordingly, the legal opinion that an institution obtains in connection with recording the securitization as a sale should also address whether the rights to the AIR cash flows have been legally isolated from the transferor, even in the event of the transferor’s bankruptcy or other receivership.

An institution with a securitization structure that differs from the fact pattern described in this guidance should ensure its accounting approach is consistent with GAAP. Such institutions may contact their appropriate federal banking agency for further guidance, if appropriate.

to finance charges that have been accrued on cardholder accounts, but have not yet been billed (“accrued but unbilled”).

While the selling institution retains a right to the excess cash flows generated from the fees and finance charges collected on the transferred receivables, the transferor generally subordinates its right to these cash flows to the investors in the securitization. The seller’s right to the excess cash flows related to the AIR asset is similar to other subordinated residual interests in securitized assets in that the AIR serves as a credit enhancement to protect third-party investors in the securitization from credit losses.⁴ If and when cash payments on the accrued fees and finance charges are collected, they flow through the trust, where they are available to satisfy more senior obligations before any excess amount is remitted to the seller. Only after trust expenses (such as servicing fees, investor certificate interest, and investor principal charge-offs) have been paid will the trustee distribute any excess fee and finance charge cash flow back to the seller. Since investors are paid from these cash collections before the selling institution receives the amount of AIR that is due, the seller may or may not realize the full amount of its AIR asset.

Appropriate Accounting Treatment for Accrued Interest Receivable

Accounting at Inception of the Securitization Transaction

Generally, if a securitization transaction meets the criteria for sale treatment and the AIR is subordinated either because the asset has been isolated from the transferor (see paragraph 9(a) of FAS 140) or because of the operation of the cash flow distribution (or “waterfall”) through the securitization trust, the total AIR (both the “billed and uncollected” and “accrued and unbilled”) should be considered to be one of the components of the sale transaction. Thus, when accounting for a credit card securitization, institutions should allocate the previous carrying amount of the AIR (net of any related allowance for uncollectible amounts) and the other transferred assets between the assets that are sold and the retained interests, based on their relative fair values at the date of transfer. As a result, after a securitization, the allocated carrying amount of the AIR will typically be lower than its face amount.

Subsequent Accounting

After securitization, the AIR asset should be accounted for at its allocated cost basis (as discussed above). In addition, institutions should treat the AIR as a retained (subordinated) beneficial interest. Accordingly, it should be reported in “Other Assets” in regulatory reports⁵ and not as a loan receivable.⁶

In addition, because the AIR is a retained beneficial interest, institutions should follow the guidance provided in FASB Emerging Issues Task Force Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets” (EITF 99-20), in subsequent

⁴ Examples of other retained interests in securitized assets include an Interest-Only Strip and a Cash Collateral or “Spread” account.

⁵ In the Call Report, the carrying value of the AIR asset should be reported in Schedule RC-F, item 5, and in Schedule RC-S, item 2.b, column C (if reported as a stand-alone asset). In the TFR, the AIR should be reported in Schedule SC, line SC 690, and Schedule SI, line SI 404.

⁶ In addition to the regulatory reporting requirements described in the above footnote, the agencies note that for financial statements prepared in accordance with GAAP, the AIR asset would be subject to the disclosure requirements pertaining to retained interests in securitized financial assets that are specified in paragraphs 17(f) and 17(g) of FAS 140.

accounting. EITF 99-20 specifies the accounting approach that an institution should follow to evaluate a retained beneficial interest for impairment and how to account for any impairment that occurs.

Relationship Between the Accrued Interest Receivable and the Interest-Only Strip Asset

In assessing whether the AIR is appropriately measured for regulatory reporting purposes, institutions should carefully consider the accounting treatment for the Interest-Only Strip asset. The Interest-Only Strip and the AIR are closely related. Both represent the seller's subordinated beneficial interest in excess cash flows from the trust. Despite their close relationship, these cash flows have different risk characteristics. The AIR represents the right to receive the cash flows from fees and finance charges that have already accrued on cardholders' accounts. The Interest-Only Strip, on the other hand, represents an estimate of cash flows from fees and finance charges that will accrue on cardholders' accounts in the future. Because the Interest-Only Strip cash flows can be contractually prepaid or settled in such a way that the seller would not recover substantially all of its investment, the Interest-Only Strip must be accounted for at fair value like a trading or available-for-sale security in accordance with paragraph 14 of FAS 140. In contrast, the AIR cannot be contractually prepaid or otherwise settled in such a way that the owner would not recover substantially all of its recorded investment.

Institutions should consider the close relationship between these assets and ensure that the amount of assets recognized for the right to receive excess cash flows from securitizations, in total, is not overstated. In addition, institutions should describe the accounting treatment for the AIR and the Interest-Only Strip in their accounting policies and related disclosures and be able to demonstrate that their accounting approach is consistent with GAAP. Examiners will review this documentation when evaluating an institution's accounting for securitization activities.

Additional Information

For further information on the appropriate risk-based capital treatment for the AIR asset, please contact Thomas G. Rees, Deputy Chief Accountant at the OCC, at (202) 874-5411; Robert F. Storch, Accounting Section Chief at the FDIC, at (202) 898-8906; Charles H. Holm, Assistant Director, at the Board, at (202) 452-3502; Timothy J. Stier, Chief Accountant, at the OTS, at (202) 906-5699.