OCC ADVISORY LETTER

Comptroller of the Currency
Administrator of National Banks

Subject: Secured Credit Cards

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

PURPOSE

Through its examination and other supervisory activities, the OCC has identified a number of issues presented by certain secured credit card programs, including credit, compliance, and reputation risks and the potential for inappropriate treatment of customers. This advisory letter is intended to help national banks identify risks that are presented by these credit products and to provide guidance on how to address such risks, so that national banks that elect to offer secured credit cards do so in a safe and sound manner that treats customers fairly and promotes responsible credit access.

This advisory letter also discusses the OCC's particular concerns regarding secured credit card programs in which security deposits (and fees) are charged to the credit card account, with the result that the consumer has little or no available credit or card utility at account opening. In addition to presenting increased risks of default, customer confusion, and other adverse consequences, this structure may constitute an unfair practice under the applicable standards of the Federal Trade Commission Act (FTC Act). Accordingly, the OCC has determined that this type of secured credit card product is not appropriate for national banks, and should not be offered by them.

BACKGROUND

As a general matter, secured credit cards look and function like traditional, unsecured credit cards, but the credit extended by the issuer is wholly or partially secured by collateral of the borrower (typically a bank deposit). Secured credit cards generally are marketed to individuals with limited or blemished credit histories who may not be eligible for unsecured credit, and may serve as a means for those individuals to establish or improve their credit histories and as a stepping-stone to unsecured credit. These products also may function as a form of identification, and, depending on the terms and structure of the program, may be less expensive for these individuals than other forms of available credit.

In a traditional secured credit card program, funds are transferred to the issuing bank by the consumer at account opening, pledged as security for the credit card account, and placed on deposit (at the issuer or another depository institution) in the name or for the benefit of the consumer. The consumer generally may not access those funds, however. Rather, the funds remain on deposit so that if the consumer defaults on his or her credit card account, the deposited funds may be used to help satisfy the debt. Minimum bank deposits under secured credit card programs typically range from $100 to $500, although customers often are permitted to deposit more if they so choose. Interest may or may not be paid on the deposit, depending on the terms of the agreement.

The interest rate, credit line, and other features of the card will vary depending upon the specific terms of the program. Application, annual, and other fees may be assessed, but are not charged by all issuers of these products. The credit line on the card generally will be tied to the amount of the security deposit. Depending on whether the product is fully or partially secured, the credit line on the card typically ranges from 100 percent to 200 percent of the deposit. In some programs, the credit line may be increased by the issuer based on the consumer's good payment history. Similarly, some issuers offer specific "graduation" programs in connection with their secured credit cards through which customers may be eligible for unsecured credit after a designated period of good payment history. In general, however, cardholders are not graduated automatically to unsecured products, but must apply for such credit when eligible.

Secured credit cards are generally marketed to two distinct populations. The first consists of individuals with little or no credit history who might be able to progress relatively quickly to an unsecured product. This group includes recent graduates, immigrants, and other individuals seeking to establish credit in their own names. The second group of consumers to receive secured card marketing includes individuals with poor credit histories of varying severity.[1]

PRINCIPAL RISKS AND CONCERNS

Special Concerns Regarding Certain Secured Credit Card Structures

As noted above, certain secured credit card structures — specifically, where the security deposit is charged to the card upon issuance, with the result that the consumer has little or no available credit or card utility — have raised particular concerns for the OCC. These structures have presented increased risks of customer confusion, consumer abuse, default, and promotion of irresponsible credit behavior.

The OCC has found that solicitations and other marketing materials used for these credit card programs have not adequately informed consumers of the costs and other terms, risks, and limitations of the product being offered. In these marketing campaigns, the fact that the consumer need not furnish any funds to open the account may be prominently featured as a benefit of the issuer's secured credit card program. However, the adverse effects of this structure for the borrower are omitted or obscured. These adverse effects may include:

- Significant diminution or elimination of available credit and the consumer's ability to use the card (because the credit line is fully utilized by the loan of the security deposit funds and, in some cases, the issuer's charging applicable fees directly to the card);

[1] The OCC has previously noted the important differences between these groups and urged national banks to recognize these differences in their underwriting, portfolio analysis, and account management practices. *See, generally,* OCC Bulletin 99-15 (Subprime Lending: Risks and Rewards), April 5, 1999.

- Significantly increased costs to the consumer (principally as a result of interest being charged on the amount “loaned” for the security deposit and fees) as compared with an account in which the consumer provides the security deposit from separate funds;[2] and
- An enhanced likelihood of default (and the adverse effect on credit history that would result).[3]

In a number of cases, disclosure problems associated with secured credit cards and related products have constituted *deceptive* practices under the applicable standards of the FTC Act, and the OCC has taken appropriate enforcement actions to address these problems.[4] These enforcement actions, and the existence of consumer complaints, underscore the increased customer confusion and compliance and reputation risks presented by this type of secured credit card.

Secured credit cards structured in this manner also raise, in addition to these issues of disclosure and deception, a substantial likelihood that they could be found to be *unfair* under the applicable standards of the FTC Act. Such a finding could be based, for example, on the fact that because charges to the card by the issuer utilized all or substantially all of the nominal credit line assigned by the issuer, they eliminated the card utility and credit availability applied and paid for by the cardholder. Thus, even apart from particular disclosure issues, this type of product carries a potential for consumer abuse that raises significant compliance and reputation risks.

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[2] In one program reviewed by the OCC, most consumers paid a $39 application fee and were assigned a $260 credit line. The issuer charged a $200 security deposit and certain additional fees to the card upon issuance, leaving the consumer with less than $10 in initial available credit. The stated APR on the card was nearly 20 percent, and the issuer paid a de minimus rate of interest on the security deposit. A consumer who made no retail purchases or other transactions with the card, but made all required payments on the account in a timely fashion, would have paid the issuer approximately $200 during the first year of the account, but would have available credit of less than $50. Even after two years, such a consumer would have approximately $100 in available credit, while having paid the issuer nearly $400. Available credit would approximate the nominal amount of the credit line only after four years, by which time the consumer would have paid the issuer almost $750.

Under such terms, only a very small proportion of the amount paid by a consumer over time would represent payments of principal and interest on funds that have been advanced to the consumer for purchases or otherwise to be used by the consumer at his or her discretion. Moreover, the total cost to the consumer of obtaining these funds, expressed as a percentage, is likely to be many times the disclosed APR for the account. The issuer’s collection of interest that is primarily interest accrued on the amount “loaned” for the security deposit is itself a questionable practice in view of the fact that this amount represents merely a bookkeeping entry rather than separate collateral that acts to protect the creditor in the event of default.

On the basis of the deceptive marketing of this product, the OCC brought an enforcement action against the issuer. The OCC ordered the issuer to make improvements in the marketing of the product and to provide monetary restitution to affected consumers.

[3] These concerns about the marketing of this type of secured credit card are exacerbated in cases in which the product is promoted as a credit-repair vehicle, or where the issuer’s underwriting of the credit is insufficient to establish the consumer’s ability and willingness to repay in accordance with the terms of the loan.

[4] The specific practices criticized in these enforcement actions have included: (1) making misleading statements, such as “send no money” or “no savings deposit required,” in situations in which a security deposit will be charged to the consumer’s card upon issuance; (2) making statements or omissions likely to mislead consumers about the fact that significant fees would be charged to the card at account opening and result in little or no credit availability or card utility; and (3) making misleading statements or omissions — for example, affirmative representations about the consumer’s ability to use the card to obtain cash advances in an emergency — regarding the effect on card utility of charging the security deposit to the card.

Finally, the available evidence suggests that structuring secured credit cards in this manner increases the risk of consumer default on the account. In particular, the OCC's supervisory experience with and analysis of different secured credit card products indicates that the practice of charging the security deposit to the nominal credit line assigned to the consumer increases the probability of default as compared to programs in which the borrower must submit the deposit from separate funds. This is particularly true when the security deposit and fees deplete the credit line so as to provide little or no card utility or credit availability upon issuance. In such circumstances, when the consumer has no separate funds at stake, and little or no consideration has been provided in exchange for the fees and other amounts charged to the consumer, the product may provide a disincentive for responsible credit behavior and adversely affect the consumer's credit standing.

Similar risks and concerns are presented by unsecured credit card programs under which the nominal credit line is consumed by fees or by devices (such as "refundable account holds") that function, in many respects, similarly to a security deposit charged to the card. These risks and concerns would be exacerbated when the consumer is uncertain about the amount of his or her nominal credit line or the manner in which fees and other charges would be applied to the credit line, and thereby less able to appreciate the impact of these charges on card utility and credit availability.[5]

Compliance, Credit, and Other Risks Regarding Secured Credit Cards

Compliance, credit, and other risks also are presented by other types of secured credit cards, in particular, secured cards in which the security deposit is paid by the consumer out of separate funds and partially secured products that provide consumers with substantial card utility and credit availability upon issuance (even after the security deposit and any applicable fees are charged to the account). Issues may arise with these types of secured credit cards especially when they have complex features and are offered to a relatively inexperienced, unsophisticated, and higher-risk customer population.

In addition to complying with the technical disclosure and other requirements of the Truth in Lending Act and the Truth in Savings Act, issuers of these products must be careful to ensure that their marketing solicitations, disclosure documents, and other materials provided to consumers do not violate the FTC Act's prohibition against unfair or deceptive acts or practices.[6] Failure to satisfy these legal standards would not only injure a bank's customers, but also could harm the bank's reputation and expose it to civil litigation and administrative enforcement actions.

Secured credit cards also carry credit risks and implicate other safety and soundness considerations. In general, secured credit cards carry the risks of (and require the controls appropriate for) credit card operations and higher-risk lending activities.

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[5] In cases involving unsecured credit card products in which significant fees are charged to the card, and may be nearly as large as the nominal credit line, institutions have generally recognized these fees as income and capitalized them. These capitalized fees may represent a very substantial portion of total assets for issuers focusing on this product. Credit card issuers should establish reserves for accrued but uncollectible interest and fees. *See, generally,* OCC Bulletin 2003-1 (Account Management and Loss Allowance Guidance), January 8, 2003.

[6] *See, generally,* OCC Advisory Letter 2002-3 (Guidance on Unfair or Deceptive Acts or Practices), March 22, 2002.

As an initial matter, to the extent that credit lines exceed the funds placed on deposit, partially-secured cards represent unsecured credit to higher-risk borrowers. Unsecured credit may be inappropriate to many of these consumers before they have demonstrated a sustained positive payment history. Partially secured products, therefore, carry significant credit risk unless they are offered only to consumers whose credit standing indicates the willingness and ability to service and repay the loans made under the account.

National banks also should recognize that even fully secured credit cards carry significant potential credit risks. These risks arise predominantly from the possibility that certain transactions (such as overseas purchases or low dollar amount transactions) may be performed with the card outside of real-time authorization systems, with the result that the account balance exceeds the assigned credit limit. Similarly, unsecured credit risk also may arise when payment on the card is made by the consumer from an account with insufficient funds, and the consumer uses the apparent available credit created by this payment before the payment is dishonored.

Finally, the OCC's supervisory experience indicates that certain fee structures may increase the likelihood that consumers will fail to make payment in accordance with the terms of the account. In particular, products carrying fee structures that are significantly higher than the norm pose a greater risk of default.

RECOMMENDED PRACTICES

The OCC recommends that national banks offering secured credit cards (or products raising similar risks and concerns) adhere to the following guidelines in order to address the issues identified in this advisory letter.

Product Marketing and Related Matters

- Adhere to OCC Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices," in order to avoid engaging in unfair or deceptive acts or practices.

- Take affirmative steps to ensure that marketing and other materials contain prominent and readily understandable disclosures of the material costs, risks, terms, and other characteristics — including conditions and limitations — of the product being offered. Avoid using words or phrases (such as "refundable account holds") that are not likely to be understood by consumers and could obscure understanding of the terms of the product.

- Take special care to ensure that customers understand the nominal credit line and available credit at account opening that they are being offered. If a range is possible, consumers should be told the lowest and most likely credit lines and amounts of initial available credit they may receive as prominently as they are told the highest amounts.

- Avoid marketing secured credit cards as credit repair,[7] credit establishment, or credit improvement products without clearly explaining the consequences of default, or if the

[7] Materials stating that a consumer's credit will be "repaired" pose a special risk of consumer confusion because customers may believe that their bad credit history will rapidly be removed from their credit report.

structure or costs of the product tend to increase the risk of default. More generally, issuers should not employ language that implies that the card carries advantages that it does not, and should avoid marketing techniques that highlight a particular benefit of a product if that benefit will be negated by another aspect of the offering.

- Always report customers' payment performance, including positive performance, to credit bureaus.

- Avoid generally the marketing of credit disability or credit life insurance products in connection with credit cards that will be secured by deposits.

Product Structure and Terms

- Do not offer secured credit card products in which the security deposit and/or applicable fees are charged to the card (or "holds" are placed on the card) if that practice will substantially reduce the amount of initial available credit and card utility for the consumer. Similarly, do not offer unsecured credit cards if the amount of fees charged to the card upon issuance substantially reduces the amount of initial available credit and card utility.

- Even when the consumer will receive a considerable amount of available credit, issuers should recognize that the practice of charging security deposits or other amounts to the credit card to open the account may contribute to enhanced credit risk, poor account performance, and heightened reputation and compliance risks (particularly the risk of unfair or deceptive practices). Accordingly, the OCC expects that national banks will not utilize this practice without first engaging in rigorous analysis demonstrating that the product will be underwritten, marketed, and managed in a manner that fully addresses the safety and soundness and consumer protection concerns identified in this advisory letter.

- Strongly consider offering secured credit cards only in connection with a program that provides an opportunity for "graduation" to a higher credit line — and, eventually, to an unsecured card — through incremental credit line increases based on the borrower's positive payment performance and repayment capacity. While some consumers clearly have not demonstrated creditworthiness appropriate to partially secured or unsecured credit, and should not be offered such credit at the outset, they should be provided an opportunity to progress to such products once they have shown that such products are suitable for them.

- As a general matter, charge interest and fees (including overlimit and other penalty fees) commensurate with the risks and costs associated with the product. Interest rates, fees, and other material terms that are not in line with industry practice or the issuer's terms and pricing structure for other products carrying similar risks should be carefully reviewed to ensure their appropriateness.[8] Issuers also should consider paying interest on consumers' security deposits akin to that paid on other deposits of similar amount and

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[8] National banks should carefully consider whether it is appropriate to assess credit line increase or other fees in connection with changes to account terms that are effectuated under a graduation program of the sort described above.

liquidity, and should make clear and conspicuous disclosures to consumers if they will not be doing so.

Credit Risks and Related Matters

- Implement appropriate underwriting policies, procedures, and practices prior to engaging in secured credit card activity directly or with a third-party originator or marketer.

- Ensure that secured credit cards are appropriately underwritten based on the borrower's willingness and ability to repay in accordance with the terms of the card without resorting to the deposit collateral. The required minimum payment should be sufficient to cover finance charges and recurring fees and to amortize the principal balance over a reasonable period of time.

- Establish strict controls to reduce the occurrence of over-limits and to address the timely repayment of any over-limit balances.

- Ensure that all products and account management practices, including credit line management and pricing criteria, are fully tested, analyzed, and supported prior to roll-out or broad implementation of the product or practice.

- Establish strong collection practices and fraud controls appropriate for the customer population.

- Ensure that income recognition and loss recognition practices are appropriate. Banks are expected to employ appropriate methods to ensure that income recognition is accurate.

- Establish appropriate management information systems to monitor and analyze the credit performance and profitability of the portfolio. Reporting should provide management with the necessary information to monitor and manage all aspects of the product.

- Ensure that loan loss reserves and capital adequately support the secured card activity, especially considering the higher default rates and higher-risk borrower credit profile associated with most secured card programs.

- Adhere to the risk management practices detailed in prior OCC guidance on credit card operations and subprime lending, specifically comments pertaining to underwriting, account management, collection and forbearance activities, income and loss recognition, and management information systems.[9]

[9] *See, generally,* OCC Bulletin 2003-1 (Account Management and Loss Allowance Guidance), January 8, 2003; OCC Bulletin 2001-6 (Expanded Guidance for Subprime Lending Programs), January 31, 2001; OCC Bulletin 2000-20 (Uniform Retail Credit Classification and Account Management Policy), June 20, 2000; OCC Bulletin 99-15 (Subprime Lending: Risks and Rewards), April 5, 1999; and OCC Bulletin 99-10 (Interagency Guidance on Subprime Lending), March 3, 1999.

Questions concerning this advisory letter may be directed to the Community and Consumer Law Division at (202) 874-5750, the Credit Risk Division (202) 874-5170, the Compliance Division at (202) 874-4428, or the appropriate supervisory office.

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