I. INTRODUCTION

The role of credit cards within the economy is substantial, as evidenced by both the high volume of bank credit card debt outstanding and by the astounding volume of credit card charges nationwide. Estimates are that Americans will have made $1.9 trillion in bank credit card charges in 2005. And, even with the surge of refinancing and home equity loans within the past few years, there was still about $665 billion in bank credit card debt (excluding store and gas cards) outstanding at mid-year 2005. Within the bank credit card industry, the top three **issuers** control about 60 percent of the market based on balances. Based on charge volume, their control is even more pronounced.

The size and continued growth of the credit card industry evidences the perceived value to the financial community, which includes consumers, **merchants**, and financial institutions. The credit card business is one of the most competitive markets in the world, and the intense competition pressures credit card issuers to develop and market innovative new products. Credit cards are used on a regular basis by a majority of American households to conveniently pay for a wide array of seemingly countless items and services, such as appliances, income taxes, utility bills, fast food, and charitable donations. Those consumers who maintain a strong **credit history** and manage credit responsibly generally are inundated with a wide assortment of credit card solicitations offering eye-catching interest rates and attractive perks, such as gifts, discounts, travel offers, and rebates. Those consumers with an unfavorable financial history or with a limited or absent financial history are usually offered small credit lines that are often largely consumed by a wide assortment of upfront fees and other charges and/or that require a security deposit or other collateral. The rise in credit card activities within in the financial services industry has been accompanied by increased regulatory oversight because these activities can pose a variety of substantial risks to banks, as will be discussed throughout this manual.

ABOUT THE MANUAL

This manual is intended to assist examiners in gaining a broad understanding of the unique characteristics of bank credit card operations. It highlights various facets of bank credit card operations and the examination approaches needed to analyze those operations and institutions. Bank credit card operations are subject to a dynamic competitive and legal environment. As such, examination approaches necessary to assess credit card operations may require augmentation or modification beyond the approaches provided in this manual, depending on circumstances that arise. Key factors to effectively assessing credit card operations are being adaptive in the face of change and being proactive in monitoring industry trends and movements.

This manual is to be used in conjunction with the Risk Management Manual of Examination Policies and, when applicable, the Risk Management Credit Card Securitization Manual. This manual identifies general information about credit card activities; discusses specific aspects of credit card lending operations, such as marketing, underwriting, and portfolio management; and identifies various CAMELS component considerations. Chapters about credit card issuing Rent-a-**Bank Identification Number (BIN)** activities, **merchant processing**, and third-party relationships are also incorporated. While many chapters include accounting discussions, examiners are encouraged to seek assistance from accounting subject matter experts as necessary. A glossary and appendices, including a sample pre-examination request list and merchant processing examination tools, are also included. The first use of each glossary term is underlined. The pre-examination request list is provided as an example only and should be customized for the specific bank under review.

II. CREDIT CARDS – GENERAL OVERVIEW

WHAT IS A CREDIT CARD

In its non-physical form, a credit card represents a payment mechanism which facilitates both consumer and commercial business transactions, including purchases and **cash advances**. A credit card generally operates as a substitute for cash or a check and most often provides an unsecured revolving line of credit. The borrower is required to pay at least part of the card's outstanding balance each **billing cycle**, depending on the terms as set forth in the **cardholder agreement**. As the debt reduces, the **available credit** increases for accounts in good standing. These complex financial arrangements have ever-shifting terms and prices. A **charge card** differs from a credit card in that the charge card must be paid in full each month.

In physical form, a credit card traditionally is a thin, rectangular plastic card. The front of the card contains a series of numbers that are representative of various items such as the applicable network, bank, and account. These numbers are generally referred to in aggregate as the **account number** or card number. A magnetic stripe, often called a magstripe, runs across the back of the card and contains some of the account's information electronically. The back of the card also contains a **cardholder** signature box. There are many other physical attributes to a credit card; however, as technologies progress, their physical form is morphing. For example, multi-application cards (sometimes referred to as smart cards) involve aspects of cryptography (secret codes) and, in place of the magstripe, have a microprocessor, or chip, built into the card. The enhanced memory and processing capacity greatly exceeds that of the traditional magstripe card, and the multi-application cards can enable consumers to access several financial accounts and other services or data (like merchant loyalty programs) with a single card. Emerging formats also include contactless and biometric payment options. With the contactless payment format, cards are tapped on readers (instead of swiped) at the point-of-sale. This format is also known as proximity, "tap 'n go," or blink technology. The biometric format relies on a cardholder's physical or biological features by using identification techniques like fingerprint verification, iris scans, or voice scans. Electronic payment innovations may well be only in their infancy.

INDUSTRY HISTORY

The credit card lending business experiences rapid change, but not just in the technology environment. New competitors continue to emerge from not only the banking industry, but from phone companies, retailers and others. At the same time, consolidation among credit card issuers has also increased. For example, during a four-month period in 2005, the three largest **monoline credit card banks** (MBNA, Capital One Financial Corporation, and Providian) all announced some type of acquisition transactions.[1] The credit card industry's focus has shifted from prestige to merchant acceptance to pricing and perks. Intense competition, market saturation, and changing consumer postures have forced issuers to be innovative with the credit card products offered and to develop sophisticated customer selection and management methods. Processes have evolved to risk ranking **applicants** and pricing each account accordingly. **Risk-based pricing** has allowed banks to issue cards to less-qualified applicants in exchange for a higher interest rate or other fees and to essentially offer customized card products. Rewards programs are extremely popular, and credit cards can now be used to purchase items in well over 100 currencies.

[1] According to an article entitled "Overview of Recent Developments in the Credit Card Industry" found in the November 2005 issue of the FDIC Banking Review and authored by Douglas Akers, Jay Golter, Brian Lamm, and Martha Solt.

Visa and MasterCard (together referred to as **Associations**) quickly come to mind when the term "credit card" is used. Traditionally banks purchased memberships in the Associations, and, in return, receive the right to offer credit card products or other services under the applicable Association's logo.[2] In addition to operating worldwide sophisticated payment networks, the Associations provide services including, but not limited to, advertising, statistical analysis, industry studies, and advisory services. They require their member banks to be insured and to operate within certain policies. The Associations do not issue cards or financial services directly to consumers or merchants. Rather, they focus on advancing payment products and technologies for their member banks, and the member banks manage the relationships with consumers and merchants. The Associations offer various membership grades, which can be subject to certain requirements, such as capital levels or acceptable growth projections.

While the Associations remain the prominent brands in the bank credit card industry, other brands, such as American Express and Discover, are challenging their share. Unlike the Associations, American Express and Discover traditionally both issued their own cards. While they have long been in the credit card business, they only recently expanded their access within the bank credit card business as a result of court rulings in 2004. Those rulings said that the Associations' policies barring member banks from contracting with American Express and Discover violated antitrust rules. The rulings have not only resulted in some Visa and MasterCard banks now also offering American Express and /or Discover cards, but are also leading to **dual-branding**. For simplicity, MasterCard, Visa, American Express, and Discover are collectively referred to as Networks in this manual. The term Networks is used because these companies interconnect a large and widely-distributed group of people and entities to communicate with one another and work together as a system to facilitate card transactions. The system allows for the routing of a transaction's information between the participants in a matter of fractions of a second. Payment systems for credit cards are discussed in Chapter XIX, Merchant Processing.

The legal and regulatory environment for the bank credit card industry continues to shape the industry as well. For instance, in the 1970's, the U.S. Supreme Court ruled that the lender's location, not the consumer's state of residence, determined the applicable state **usury** ceiling. As a result, large card issuers have sought out states with lender-friendly usury ceilings in which to establish national operations. For example, several bank credit card operations are located in South Dakota and Delaware. The 1970's also saw Congress enact a number of consumer credit protection laws. More recent banking regulatory developments include the issuance of subprime lending guidance in 1999 and 2001 and account management and loss allowance guidance in 2003.[3] Concepts from these documents are discussed throughout this manual.

CARD TYPES AND ATTRIBUTES

A multitude of credit card products are available to consumers, and the number of products is growing. Terms and conditions of each credit card product offered, such as the **Annual Percentage Rate (APR)**, the monthly **minimum payment** formula, and certain fees, are detailed in a cardholder agreement which is required by regulation. The following sections provide an overview of some common credit card product categories.

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[2] MasterCard became a private, SEC-registered share company whose shares were owned by the principal members of MasterCard International in 2002, and in May 2006 it announced an initial public offering and began trading on the New York Stock Exchange under the symbol "MA."

[3] March 1, 1999 *Interagency Guidance on Subprime Lending* (FIL-20-99); January 31, 2001 DSC Memorandum Transmittal Number 01-005 *Expanded Guidance for Evaluating Subprime Lending Guidance* (FIL-9-2001); and January 8, 2003 *Account Management and Loss Allowance Guidance for Credit Card Lending* (FIL-2-2003).

General Purpose Credit Cards

General purpose, or universal, credit cards can be used at a variety of stores and businesses. They take on many forms, including standard, premium, affinity, co-branded, corporate, home equity, and cash secured programs, each of which is briefly described next.

Standard Credit Card Programs:

Standard credit card programs are a traditional form of credit card issuance. These programs are usually marketed to consumers who meet or exceed the institution's minimum credit criteria but that may lack sufficient credit history or may fail to meet some of the institution's other credit criteria. Due to the higher credit risk and loss rates, these programs generally carry higher interest rates, higher fees, and lower **credit limits** than premium credit card programs. In addition to cash secured credit cards (discussed later), unsecured standard credit card programs are frequently used for providing credit to **subprime** borrowers.

Premium Credit Card Programs:

Premium credit card programs tend to be marketed to consumers that have higher income and/or higher **credit scores** than those consumers offered standard credit cards. Premium programs have traditionally consisted of gold and platinum credit cards. However, some issuers have moved toward using these premium-sounding titles with more standard-type products to combat strong competition and entice consumers to opt for their cards. Premium credit card programs usually carry lower interest rates, waived annual fees, and higher credit limits. The risk with this type of program is a large volume of high-balance accounts. Over-reliance on the premium sector creates the potential of greater losses in the event high outstanding balances exist during an economic downturn.

Affinity Credit Card Programs:

Affinity relationships are partnerships formed between financial institutions and unaffiliated groups (affinity partners), generally nonprofit organizations such as, but not limited to, alumni associations, professional organizations, and fan clubs. A contractual agreement governs the relationship with the affinity partner, and the **affinity cards** issued usually carry the affinity partner's logo. Compensation varies, but the affinity partner endorsing the card usually receives financial compensation based on the projected level of acceptance and use by its members. Compensation often comes in the form of the sharing of annual fees, renewal fees, **interchange** income, and interest income. Issuers seek affinity endorsements to increase response, usage, and retention rates.

Co-branded Credit Card Programs:

Co-branded relationships are partnerships formed between financial institutions and unaffiliated organizations, generally for-profit organizations such as airlines, automobile manufactures, and retailers. Similar to the affinity program, a contractual agreement governs the co-branded relationship, and the **co-branded card** usually carries the co-branded partner's logo. Compensation to the co-branding partner often takes the form of sharing **interchange fees** and/or rebates to its customers. Rebates to customers are normally based on a percentage of purchases or transactions, and the percentage often varies depending on whether purchases were made with the co-branding party or another entity. The institution benefits from a co-branding arrangement because it generally increases credit card receivables, and accordingly interest and interchange income, due to the consumers' willingness to use the credit card more frequently to reap the financial rewards. However, institutions typically face the risk that higher cardholder monthly payment rates could erode profits. Nevertheless, for some programs the considerable volume of interchange income generated by high cardholder transaction volumes might substantially offset the interest income opportunity that is lost with higher payment rates.

Corporate Credit Card Programs:

Corporate card programs come in more than one form to serve different business needs. In general, they are contractual agreements between a sponsoring entity and a financial institution, in which the financial institution issues corporate cards to select employees of the sponsoring company. The sponsoring entities may take on several forms including small businesses; middle market businesses; local, state, or Federal governments; and large corporations. With this type of program, examiners should determine if the institution is allowed to make commercial loans. While most banks are permitted to make commercial loans, others are prohibited by state law or charter restrictions.

Travel and entertainment (T&E) cards are used for business functions such as travel, lodging, and entertainment. The contract identifies the repayment terms and whether the sponsoring company guarantees the loans. These terms often dictate how the bank sets the credit limits.

Procurement cards are used for a business's purchases of materials, office supplies, and miscellaneous items. Businesses are attracted to this product because it simplifies accounting, especially for small-ticket items. Purchase orders are not needed, and only one payables check is necessary. In addition, institutions can provide value-added features such as detailed account statements and summary statistical information on purchasing patterns. The ability to provide value-added features is a critical competitive factor between institutions. Depending on the needs of the corporation these accounts may have credit limits in the millions of dollars.

Corporate card accounts generally pay monthly; thus, issuing banks normally forego **finance charges**, which could make past due accounts very costly to the bank. The primary source of income on these accounts consists of service fees, annual fees, and interchange income.

Home Equity Credit Card Programs:

Home equity credit cards are secured by housing assets. These credit cards provide consumers with the benefits of a traditional home equity line of credit (attractive interest rates and potential tax deductibility) while allowing them quick, easy access to the line's funds via the credit card. Home equity credit card lending involves a significant amount of documentation due to the mortgages, insurances, and other aspects involved. Points unique to these programs compared to unsecured programs include loan-to-value (LTV) and foreclosure considerations.

Cash Secured Credit Card Programs:

Cash secured credit cards are generally marketed to two consumers groups: those with poor credit scores or prior credit problems and those with a limited or non-existent credit history. These programs can allow consumers an opportunity to establish or re-establish their credit. The accounts are collateralized by savings accounts or certificates of deposits. Cash secured credit card lending can be profitable and attractive to institutions because the receivables are self funding, finance charges and fees are high, the collateral is liquid, and new markets are opened.

Proprietary Credit Cards

Proprietary cards, also called private label cards, are issued under a contractual agreement between financial institutions and third parties, usually large retailers, for the purpose of consumers transacting business with that entity. Some are also issued by the retailers and do not involve a financial institution. Private label cards often exhibit different traits than general purpose cards in that private label cards normally have lower credit limits, higher interest rates, higher credit risk profiles, and limited use (for example, limited to a particular merchant). There is risk of the retail partner failing. While significant direct exposure to the company may not be evident, high losses may still result if cardholders do not feel compelled to repay outstanding balances. Some customers may not honor obligations due to lost warranties or rights to return merchandise. Others might not repay the debt simply because the merchant is no longer in business. In either case, the bankruptcy of a retail partner usually creates a significant collection problem. In addition, credit risk is closely correlated with the traits of the cardholder population which are usually small, niche markets tending to have volatile performance patterns. The credit quality of these populations also tends to be lower because there is generally an incentive to establish liberal underwriting standards and enroll as many applicants as possible to generate business for the retail partner.

Cash Access Credit Cards

Cash access credit cards are marketed to consumers who tend to prefer cash advances over purchases. These cards are not used for traditional **point-of-sale transactions**. Cash-users are typically considered a higher-risk population. In some cases these borrowers may be using cash advances to pay debts, including balances on this or other credit cards (this can also be true for some borrowers who use cash advance features of their general purpose cards).

Other Types of Bankcards

Not all cards issued by banks are credit cards. For example, banks also issue **debit cards** and prepaid or stored value cards. Examples of stored-value cards include payroll cards, **electronic benefits transfer (EBT)** cards, travel fund cards, and store gift cards. This manual focuses on credit cards.

III. IDENTIFYING INVOLVEMENT IN CREDIT CARD ACTIVITIES

Banks are important participants in credit card systems and networks. Involvement could include:

- Directly issuing the accounts and holding the receivables.
- Directly issuing the accounts and **securitizing** the receivables.
- Purchasing credit card receivables and/or relationships.
- Renting their rights to offer credit card products under the Associations' logos to a third party in return for a fee (otherwise known as Rent-a-BINs).
- Servicing credit card portfolios, including collections and customer service.
- Providing payment **processing** and **lockbox** services.
- Providing **clearance** and **settlement** of cardholder transaction data as well as funds for the transactions.
- Serving as an **acquiring bank**.
- Serving as an **agent bank**.
- Or a combination these or other functions.

The terminology used to describe the manner in which a bank is involved in credit card activities can vary widely and continues to transform. Nonetheless, credit card lending typically has wide-spread impacts on many components of the bank, including, but not limited to, the Allowance for Loan and Lease Losses (ALLL), capital, funding, earnings, and rate sensitivity. That coupled with the dynamics of the credit card market requires the bank to carefully and attentively manage every aspect of the credit card lending process. The following sections are intended to assist the examiner in determining whether and how the bank is involved in credit card activities and include brief overviews of the activities.

CREDIT CARD SPECIALTY BANKS (CCSBs)

By definition, CCSBs focus on one type of lending – credit card lending. According to the March 2005 update of A User's Guide for the Uniform Bank Performance Report (UBPR), a bank must exhibit two features to be considered a CCSB. Their (Credit Card Loans plus Securitized and Sold Credit Card Loans) divided by (Total Loans plus Securitized and Sold Credit Cards) must exceed 50 percent. In addition, their (Total Loans plus Securitized and Sold Credit Card Loans) divided by (Total Assets plus Securitized and Sold Credit Card Loans) must exceed 50 percent.

CCSBs are one of four broad groups within the UBPR's peer group structure and are subdivided into three groups based on asset size, using 90 day average assets from Call Report schedule RC-K. CCSB peer group numbers are 201, 202, and 203 and have asset sizes of greater than $3 billion, between $1 billion and $3 billion, and less than $1 billion, respectively. Risks for these types of banks center on credit risk from the card portfolio. If securitizations are involved, the liquidity, capital, strategic, reputation, and operational risks are further impacted.

Due to the dynamic environment of the credit card industry and the participation of many banks in credit card activities in some material degree or another, this manual covers not only CCSBs but many other types of credit card operations.

RENT-A-BINS

Association members include issuing members and acquiring members. Issuing members contract with the cardholders to issue products. In other words, they sign the cardholders. Acquiring members, however, partake in the acquisition of merchants to accept credit cards as payment for good and services and also partake in the acquisition of cardholder transactions. When a bank is contracting with the Associations, it identifies which business it will conduct. Banks often specialize on one side or the other (issuer or acquirer), but can do both. Based on the type of business that will be conducted, the Associations assign one or more Bank Identification Numbers (BINs) (Visa) or Interbank Card Association (ICA) (MasterCard) numbers to member banks to identify the business purpose(s). The number is reflected as the first several digits of the account number and is used for many purposes such as issuing, processing, settling, and reporting. For simplicity, these numbers will be referred to as BINs in this manual. Members which are licensed BINs may allow other entities to conduct various credit card related activities through the member's BIN. These arrangements are typically referred to as Rent-a-BINs.

There are essentially two types of Rent-a-BINs: an issuing Rent-a-BIN and an acquiring Rent-a-BIN. A credit card issuing Rent-a-BIN is an arrangement whereby a bank "rents" its right to offer credit card products and other services under the applicable Association's logo to a third party in return for a fee. The arrangement essentially entails the bank lending its name and regulated-entity status to a credit card program operated by the third party (which may or may not be affiliated with the bank). Issuing Rent-a-BIN arrangements can take on a variety of structures. For example, some banks have arrangements with several third parties for different credit card programs, and contracts for certain portfolio services (customer service, processing, and so forth) could be with the BIN-renter or other third parties. Further, the bank might perform certain services. Under an issuing Rent-a-BIN arrangement, the bank generally transfers all or a majority of the credit card receivables off its books; however, the bank sometimes retains some or a majority of the receivables. The bank retains ownership of the card accounts and/or relationships. A contract typically governs the relationship between the bank and the BIN-renter, including specifying the responsibilities of each party. Legal, compliance, reputation, and counter-party risks are the crux of the bank's risks for issuing Rent-a-BIN arrangements. However, there are a number of other potentially significant risks, such as funding and credit risk, which can impact the bank and largely tie to the financial wherewithal and practices of the third parties involved. Additional information on issuing Rent-a-BINs is found in Chapter XIV.

An acquiring Rent-a-BIN is an arrangement whereby an acquiring bank allows an **Independent Sales Organization (ISO)** or **Member Service Providers (MSP)** to utilize (or rent) the bank's BIN number to acquire and settle merchant credit card transactions in return for a fee. Risks associated with acquiring Rent-a-BIN activities center on risk from losses (in this case **charge-backs**), counter-party risks, and legal, compliance, and reputation risks, among other risks. Acquiring Rent-a-BINs are discussed in the Merchant Processing chapter.

For both types of Rent-a-BINs, the bank retains its contract(s) with the Association(s), and as such, accountability (including financial responsibility) for activities conducted with its BINs, and hence, many of the risks. Since American Express and Discover only recently expanded their access to banks, little is known about any such branded Rent-a-BIN activities.

ACQUIRING BANK

An acquiring bank, also known as a merchant bank, contracts with (or acquires) merchants, either directly with the merchant or indirectly through **agents** or other entities, for the settlement of card transactions. Many banks serve as acquiring banks for local merchants. The acquiring bank generally owns the BIN and provides **backroom operations**. It also carries the risk of charge-backs, which can be significant, if the merchant is unable or unwilling to honor the financial liability. Other risks include transaction, liquidity, compliance, strategic, and reputation risks. Information on acquiring banks is housed in the Merchant Processing chapter.

AGENT

A definition of agent is not universally set. However, agent banks contract with merchants on behalf of an acquiring bank and are usually community banks that do not directly offer merchant processing services. Depending on each applicable contract, an agent bank may or may not retain liability for charge-backs. In addition to sourcing merchants, agents can also source cardholders or provide other services, such as back-room processing or servicing loyalty programs. The Merchant Processing chapter contains additional information on agent banks.

CEBA CREDIT CARD BANKS

A **CEBA bank** is a type of national bank charter which affects the bank's lending and deposit functions. Requirements are set forth in an amendment to the Bank Holding Company Act (BHCA), the Competitive Equality Banking Act (CEBA) Act of 1987, hence the name CEBA bank. To qualify, the bank must:

- Engage only in credit card activities.
- Not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties.
- Not accept any savings or time deposits of less than $100M unless they are used as collateral for secured credit card loans.
- Maintain only one office that accepts deposits.
- Not engage in the business of making commercial loans.

Some states have bank statutes with similar restrictions.

SECURITIZING BANK

Some banks (including some CCSBs) securitize credit card receivables. Securitization is the process by which the financial assets (in this case credit card receivables) are transformed into securities. It is a complex process, and examiners should refer to the Risk Management Credit Card Securitization Manual. That manual discusses the risks associated with securitizations, which primarily include credit, liquidity, capital, reputation, operational, and strategic risks. Banks can also be indirectly involved in securitizations, for instance if the holder of the credit card receivables under a Rent-a-BIN arrangement is using securitization(s) as a funding mechanism.

OTHER

Some banks may not meet the formal definition of CCSB but still operate large credit card departments. If the bank holds a large portfolio of receivables it can be susceptible to credit risk, and consequently, to earnings, liquidity, capital, and other risks. And, it is subject to legal, compliance, and reputation risks. Other banks, such as small community banks, might have small credit card programs that are primarily targeted to their local customer base. While the credit risk from such portfolios may not be significant in comparison to the bank's other lending operations, legal, compliance, or reputation risks may be higher. Some banks purchase credit card portfolios, thereby potentially increasing the credit risk on their books. Banks can be involved in credit card activities in a variety and combination of fashions, and examiners are tasked with identifying the type of credit card activities conducted by or impacting the bank as well as the level of risk that those activities pose.

RESOURCES

Several resources, including Call Reports, UBPRs, and bank web-sites, are available to help examiners determine whether a bank is involved in credit card activities. Examiners may also inquire about such activities as part of banker outreach and pre-examination contacts.

Call Reports contain several schedules with credit card specific line items. Some schedules and their contents include:

- RC-C – credit card loans to individuals as well as outstanding credit card fees and finance charges included those loans.
- RC-F – retained interests in accrued interest receivable related to securitized credit cards; **credit-enhancing interest-only** (IO) strips related to securitized credit cards.
- RC-K – quarterly average of credit card loans to individuals.
- RC-L – unused commitments for credit card lines, merchant credit card sales volume including sales for which the bank is the acquiring bank and sales for which the bank is the agent bank with risk.
- RC- N – past due credit card loans to individuals.
- RC-S – includes a column devoted to credit card receivables as well as a line item for outstanding credit card fees and finance charges.
- RI-B – **charge-offs** and **recoveries** on credit card loans; uncollectible credit card fees and finance charges reversed against income; separate **valuation allowance** for uncollectible credit card fees and finance charges; amount of allowance for loan and lease losses attributable to retail credit card fees and finance charges.

Examiners may also consult with their FDIC supervisors, Case Managers, and the Consumer Response Center, which is located in Kansas City, Missouri. The Consumer Response Center consolidates the processing of complaints and inquiries about FDIC-supervised institutions. However, complaints that it receives continue to most frequently be about credit cards. As part of the pre-examination planning process, the Consumer Response Center can provide a report summarizing consumer complaints about the bank[4]. Correspondence files may also house consumer complaints forwarded by the Consumer Response Center.

[4] Examiners should call 1-800-378-9581 to obtain examination pre-planning requests and other information from the Consumer Response Center. Consumers' complaint and inquiry calls should generally be made to the ASKFDIC line at 1-877-275-3342, which offers a wider range of business hours.

IV. CREDIT CARD PROGRAM DEVELOPMENT

The board of directors is responsible for conducting the bank's affairs, including credit card activities. Credit card programs differ considerably among banks because a myriad of factors influence the lending environment. In general, factors include the type of institution, management's objectives and philosophies on diversification and risk, the accessibility of funds, credit demand, and available expertise. Establishing and maintaining a successful credit card program requires careful management attention to ensure that the risks (such as credit, market, operating/transaction, reputation, strategic, compliance, legal, and liquidity) are addressed. Active planning and oversight; competent personnel; adequate policies, processes, and controls; a comprehensive appropriate audit program and internal control environment; and effective risk monitoring and Management Information Systems (MIS) all demonstrate sound management practices that examiners should look for.

Examiners are tasked with determining whether management has ensured, prior to engaging in credit card lending, that proposed activities are consistent with the bank's overall business strategy and risk tolerances. Such an expectation applies to any type of credit card activity, including, but not limited to, purchasing a credit card portfolio or originating its own portfolio. Proceeding slowly and cautiously while developing the program helps minimize the impact of unforeseen personnel, technology, or internal control problems and determine if profitability estimates are realistic and sustainable. Examiners should look for evidence that the decision to implement any new project or program has been based on a thorough quantitative and qualitative analysis of the bank's current operations as well as the impact of the proposed program on the bank's future operations. Examiners should determine whether management adequately provides for proper identification, measurement, monitoring, and controlling of the risks of credit card activities, both in the program development stages and while offering credit card programs.

PLANNING

A vital part of the board's responsibilities is to set the future direction of the bank, and sound planning is indispensable in dealing with the uncertainty and rapid change that permeates the credit card industry. The ability of management to plan for, and respond to, risks that may arise from changing card industry conditions or from the initiation of new credit card activities or products is imperative to establishing and maintaining successful credit card programs. As is the case with planning for other bank activities, planning for credit card activities will not be effective unless it is dynamic, carefully attended to, and well supported. Projections must be revised periodically as circumstances change and as new strategies are devised to meet stated objectives. An inadequate or ill-conceived planning process in an increasingly competitive marketplace has and can be a contributing cause of bank failure.

When determining the adequacy of management's planning process, examiners should consider the formality of the planning process in relation to the size and sophistication of the activities conducted (or proposed), the composition of the team involved in the process, the realistic nature of assumptions used, the monitoring of performance against plan, and the consideration of alternative plans in response to changing conditions. Examiners should not only evaluate the process, but should also evaluate the plan itself, taking into account the personnel, financial resources, and operating circumstances and conditions unique to the bank. When the goals and objectives chosen by directors are likely to or have resulted in significant financial harm to the bank, examiners are tasked with identifying the deficiencies in the plan and attempting to effect necessary changes. Glaring weaknesses in the plan or the absence of a satisfactory planning process are considered in the appraisal of management.

Risk Assessment

Management is responsible for performing a comprehensive and effective risk assessment consistent with the size and nature of the planned credit card activities prior to engaging in such credit card activities. Examiners should look for evidence that all involved parties have properly acknowledged and addressed critical business risk issues and that the risk assessment process is well-documented, extends beyond credit risk to appropriately incorporate other applicable risks, and considers external and internal factors. Common external factors that influence the risks include, but are not limited to: technology changes, competition, economic conditions and forecasts, political and regulatory conditions, and accounting guidance. Common internal factors that influence the risks include, but are not limited to: staffing, funding, information systems, growth, and risk appetite.

Subprime Lending

As part of the planning process, management might consider whether or not they intend to target the **subprime** market and/or purchase subprime credit card loans. Well-managed subprime credit card lending can be a profitable business; however, it is a high-risk activity and, as such, receives intense regulatory scrutiny. Successful subprime credit card lenders carefully control the elevated credit, operating, compliance, legal, market, and reputation risks as well as the higher overhead costs associated with more labor-intensive underwriting, servicing, and collections. For banks that are targeting the subprime market or purchasing subprime credit card loans, examiners should determine whether management has a clear understanding of the business and its inherent risks and has determined these risks to be acceptable and controllable given the bank's staff, financial condition, size, and level of capital support. Additional comments on subprime credit card lending are interjected in applicable sections throughout this manual.

Management Expertise and Staffing Needs

Examiners should identify whether the board has ensured that management and staff possess sufficient expertise to appropriately manage the risks involved with credit card lending and that staffing levels are adequate for the planned volume and complexity of the activity. Credit card lending requires specialized knowledge and skills, and, as such, the selection of competent management is critical to the successful operation of a bank's credit card program. Examiners are tasked with determining whether management has sufficiently identified key positions needed to carry out the program(s) and developed written descriptions of the positions' qualifications, responsibilities and expectations. Staffing levels are expected to be commensurate with the nature and volume of card activities undertaken. For example, entities engaging in higher-risk programs, such as those targeting the subprime market, may require additional collection staff compared to those conducting lesser-risk programs. Examiners should review the bank's organizational chart, staffing levels for credit card operations, and the qualifications of management to determine whether management and operational expertise as well as staff size are commensurate with the size, complexity, and risk profile of the bank and its credit card programs. Other examination tasks include ascertaining the appropriateness of salary levels and compensation arrangements and, if management relies on external advisors or consultants, determining whether the reliance is effective and properly managed.

Laws, Regulations, and Other Guidance

A keen awareness of the applicable and ever-changing laws, regulations, and other guidance is also key to the successful establishment and operation of credit card activities. Some laws, regulations, and guidance apply to all types of credit card programs. For example, the *January 8, 2003 Account Management and Loss Allowance Guidance for Credit Card Lending* generally applies to all banks that offer credit card programs. Other guidance, such as the *March 1, 1999 Interagency Guidance on Subprime Lending*, only applies to specific types of credit card lending (in this case, subprime). A wide assortment of other laws and guidance also apply, including, but not limited to, state laws and Association rules.

Examiners should review management's system to effect and monitor compliance with the laws, regulations, and guidance. Systems that lack provisions for training personnel or for making corrections as quickly as possible when violations do occur are normally cause for concern.

Committees

When determining an appropriate organizational structure in relation to planned activities, the board often appoints and authorizes committees to perform specific tasks and supervise certain phases of credit card operations. Examples of committees commonly encountered include:

- Underwriting Committee.
- Collections Committee.
- Credit Policy Committee.
- Marketing Committee.
- Audit Committee.
- Funds Management Committee.
- Securitization Committee.

Examiners should evaluate whether the committee structure reflects careful consideration by the board for ensuring that it is effective and adds value to the organization. Use of committees does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of committee meeting minutes commonly is not only a standard part of board meetings, but of examinations as well. Examiners review the committee structure (including charters and member lists) and sample the committee minutes to determine whether the board has provided a valuable committee structure that is consistent with the size, complexity, and nature of the bank and its credit card activities and that each committee is effectively fulfilling its role.

Policies and Procedures

The depth and detail of written policies varies, depending on the nature, scope, and complexity of the credit card operations. However, all banks should have written policies which are relevant to the bank's needs and circumstances and readily understood by all affected parties. Such policies should be in place before engaging in credit card activities and kept up to date thereafter.

Guidelines within lending policies demonstrate management's risk philosophy and strategic goals. Adherence to the policies demonstrates its ability to communicate, implement, and carry-out the directives. While not exhaustive, the following items illustrate broad areas of consideration almost always necessary to be addressed in the bank's lending policies.

- Guidelines governing the types of card products offered, methods of soliciting accounts, use of credit **scoring** systems, and the analysis of applicants.
- Goals for portfolio mix and risk diversification.
- Guidelines for interest rates, fees, and terms of repayment.
- Standards for documentation.
- Criteria for approving applicants and determining credit lines.
- Procedures for overriding policy and/or scoring system recommendations.
- Procedures for **authorization** and credit line increases as well as practices to **reissue** cards.
- Requirements for risk-identification systems and portfolio review, including monitoring delinquency and other asset quality indicators.
- Guidelines for the maintenance of an adequate ALLL and/or other loss allowances.

- Procedures for reducing or freezing credit lines.
- Guidelines for collections, including criteria for **re-aging** accounts, procedures for delinquency notification, and rules for using workout or other collection programs.
- Procedures for placing accounts on nonaccrual.
- Controls to prevent and detect fraud.
- Lending limits for credit analysts, supervisors, and officers.
- Charge-off guidelines.
- Adherence to consumer compliance rules and regulations.

Expanded discussions and examples of policies of particular importance are discussed in applicable sections of this manual. Those policies may act as stand-alone policies or may be incorporated into the lending policy. Examples include, but are not limited to:

- Marketing Policy.
- Underwriting Policy.
- Account Management Policies such as:
  - Re-aging Policy.
  - **Over-limit** Policy.
  - Collection Program Policies.
  - Credit Line Management Policy.
- Securitization Policy.

An appraisal of policy adequacy and the adherence thereto is one of the most important aspects of the examination process. For example, the conclusions regarding the condition of the bank and the quality of management are usually weighted heavily by findings during policy review. In addition to identifying the credit card policies used and assessing the policies' adequacy, examiners should also look for evidence that management has appropriately considered the bank's credit card activities in other bank policies, such as those covering asset/liability and funds management, profit planning and budgeting, capital planning, internal routine and controls, audit programs, consumer compliance, and vendor or third-party management. Examinations generally also include identifying whether management evaluates the effectiveness of, reviews, and revises policies as needed. When reviewing the policies, examiners gain an understanding of management's risk philosophy and strategic goals, the volume (or allowed volume) of credit card loans in relation to the bank's asset structure, the inherent risk of loss in the loans, and how the risk may impact not only the asset quality rating but other component areas as well.

Information System Needs

Examiners should confirm whether directors have considered information system needs relative to the planned credit card activities. Concern arises when management has not developed and implemented information systems that provide sufficient and accurate data to make informed decisions and to effectively monitor and manage credit card operations. Information system requirements vary depending on the size and complexity of the credit card operations but generally include the capability to provide information in a variety of ways (such as portfolio by portfolio; managed, securitized, and owned). An effective information system includes information from a number of sources, and the information serves a number of users, each having various needs. Quality, quantity, and timeliness are factors that determine the effectiveness of the information system environment. Examiners should verify the board's practices for ensuring that it receives pertinent information about the bank's credit card operations in concise, meaningful, and written form and management's practices for making certain that directors are kept fully informed on all important matters and that the records clearly reflect this.

Audits and Internal Controls

Examiners expect directors to remain well informed of the adequacy, effectiveness, and efficiency of accounting, operating, and administrative controls as well as the quality of ongoing credit card operations. Examiners should determine whether the board has carefully considered the extent of auditing needed to effectively monitor operations, internal controls, and financial reporting. Proper determination of necessary audit resources, either internal or external, considers the nature, complexity, and risk profile of the credit card activities as well as of the bank itself. Factors such as the dynamics of the card industry or increases in asset size normally result in the need for a continually growing and changing series of interrelated operating procedures, and these changes normally require management to periodically review and update the internal control system to ensure its effectiveness.

Testing and Product Roll Out

The intense competition within the credit card industry sometimes results in substantial pressures on management to roll out new products and marketing campaigns quickly, without customary and effective testing, in the hopes of capturing a product market before competitors. Product roll out without proper testing can result in substantial risk to the institution, including, but not limited to, sizable credit losses. In establishing a credit card program, management should ensure that it provides proper time and attention to product testing and roll out.

Examiners should evaluate the bank's testing and product roll out procedures including identifying the analytical procedures used to project the results of a particular solicitation or product and determining how management verifies projections before proceeding with a full-scale program. Management's testing timeframes may vary depending on the complexity of the product involved, but if the testing timeframe does not cover a sufficient period to properly determine performance, risk to the bank could be substantial. Testing methods are discussed in the Marketing and Acquisition chapter.

V. MARKETING AND ACQUISITION

The intense competition in the credit card industry coupled with the relative saturation of the market makes generating new accounts extremely challenging. Attaining new and retaining existing accounts, which are crucial for a successful credit card operation, may be a long-term challenge for card issuers. Examiners should look for evidence that the marketing function remains effective, well-developed, and carefully attended to no matter how challenging the market becomes. Marketing plays a critical role in determining asset quality, and ineffective or inappropriate marketing practices can subject the bank to elevated risks, including, but not limited to those regarding credit, reputation, and compliance. For example, aggressive solicitation programs could increase the bank's credit risk if the resulting credit card accounts experience higher-than-projected delinquencies and losses. The bank could suffer financial stress from sizeable collection costs, excessive credit losses, substantial financial penalties, or other matters. The ability to effectively attract credit-worthy consumers hinges on marketing's ability to identify, target, and attract desirable borrowers.

Marketing programs vary widely and can be as simple as offering credit cards to existing bank customers through "take one" **applications** in the bank's branches or as complex as selectively soliciting consumers in a large, nationwide mail campaign. Marketing programs are designed to promote loan growth and improve earnings, are expensive, and are not without risks. Examiners should assess management's practices for clearly defining and controlling marketing processes. They should also identify whether the bank's marketing plan is detailed, realistic, and consistent with the bank's overall strategic plan. Involvement of all applicable functional areas of the bank (such as credit risk management and information technology) is necessary to help ensure that all risks are sufficiently addressed. Necessary components of a successful marketing operation include experienced and competent management and staff, reliable projections and market analysis, and complete and accurate MIS. Examiners should review management's practices for reviewing marketing materials, consumer disclosures, and product features and terms prior to implementing marketing initiatives. Such practices by management aid in identifying and addressing potential discriminatory, unfair, deceptive, abusive, and predatory lending practices.

MARKETING CHANNELS

Conventional Mail Delivery

Conventional mailing campaigns remain the most prominent marketing channel. Mail marketing can take on a variety of forms and may include pre-screened offers and application solicitations. The term "direct mail" is commonly used and generally refers to mail directed to a specific consumer. In 2005, over six billion credit card offers were mailed.[5] While the volume of card-offer mailings is immense, response rates are nominal and declining. Direct mail response rates, which were 1.2 percent in 1998, declined to 0.2 percent in the first quarter or 2006.[6]

Online Methods

With the rise of electronic environments, online marketing is popular and has many forms. For example, banks advertise credit cards on their own web sites, on facilitator sites (sites that promote a variety of cards from various issuers), with banner ads, and with email solicitations. They also use search engine marketing or optimization techniques which help steer consumers to the bank's web site. Emerging online methods to market bank services, which potentially

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[5] According to an April 28, 2006 article entitled "Card Mail 2005" on CardWeb.com, Inc.'s CardTrak web site.
[6] According to a June 13, 2006 article entitled "CardMail" on CardWeb.com, Inc.'s CardTrak web site.

could include credit cards, include **podcasts** and **blogging**. With online marketing, the bank is often reliant on consumers seeking out the bank and may experience **adverse selection**.

Email solicitations fall under the purview of the *Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN SPAM)*. Interagency procedures for examining compliance with CAN SPAM and the *Telephone Consumer Protection Act of 1991 (TCPA)* were distributed on December 14, 2005, and should be considered when reviewing email solicitations as well as telemarketing. While these procedures are normally completed during compliance examinations, risk management examiners should be mindful of the general requirements of CAN SPAM and TCPA and should consult with their compliance counterparts when they identify any potential concerns regarding the bank's compliance with these regulations.

Outbound Telemarketing

With outbound telemarketing, marketers contact the consumer via a telephone call or message. The Federal Communications Commission (FCC) has issued regulations that establish a National Do Not Call Registry as well as other modifications to the TCPA. The FCC regulation expanded coverage of the National Do Not Call Registry by including banks. FTC telemarketing regulations parallel the FCC regulations and apply to other business entities, including third parties acting as agents or on behalf of a bank.

Telemarketing is also subject to a number of other restrictions. Among the restrictions are time-of-day limitations and rules regarding the use of automated telephone-dialing equipment. Use of automated dialers is a standard industry practice, and telemarketers are expected to employ consumer-friendly practices when utilizing such technology. For telemarketing programs, risk management examiners should be mindful of the TCPA guidance mentioned in the Online Methods section of this chapter and should consult with compliance counterparts as needed.

Television

While many banks use television to advertise traditional banking activities, television advertising specific to credit cards is mainly used by the larger issuers that offer nationwide programs. The costs of this type of marketing are often high, and the results are usually difficult to predict. The quality of responders to television ads is highly sensitive to the time slot of the ad, the programming during which the ad runs, and the tone and content of the ad.

Print Ads

Print ads include ads such as those found in magazines, newspapers, or other publications. They usually provide the consumer with a phone number and/or web-site address to use to apply. These advertisements are essentially directed to the general public but have a target market to some extent based on the traits of the publication's typical readers.

Special Event / In-Person Promotions

Banks use special event or in-person promotions in which bank representatives may be physically on location at a venue, such as a sports event, to advertise the products to the event's attendees and participants. These promotions often include "take one" applications.

"Take One" Promotions

"Take one" promotions involve applications that the customer can "take" from various locations, such as the bank's branches or other locations. It most often involves applications or brochures placed in the sight of consumers, such as on counter-tops or at the point-of-sale.

MARKETING AND ACQUISITION METHODS

There are several distinct methods of attaining new accounts, including pre-approved solicitations, applications, and portfolio acquisitions. All require prudent underwriting practices to achieve and maintain sound credit quality.

Pre-Approved Solicitations

Pre-approved offers account for a sizeable percentage of credit card enrollments. They are marketing campaigns where a firm offer of credit is made to a list of prospects, usually by conventional mail but sometimes by phone or email. Problems may arise if management has not determined, prior to engaging in pre-approved solicitations, whether its systems are adequate to capture needed data. For example, systems often must be able to capture a multitude of information, including scores, the number of customer responses, and approval/denial reasons.

The pre-approved solicitation process involves developing specific credit criteria from which the final solicitation list will be developed. The screening criteria include both credit criteria and exclusion criteria. This process normally involves a joint effort by the marketing and risk management groups. In general, the marketing group identifies the target population, the type of product, and the marketing costs while the risk management group establishes the screening criteria, sets credit limits, and monitors the campaign's success.

The target population can be derived from either a general **credit bureau** search based on specific criteria or lists developed by the bank using either internal information or lists acquired from third parties or affiliates. When the bank develops a preliminary list from either internal or acquired sources, pre-bureau list processing (scrubbing) could be completed by the bank or a designated third-party before providing the list to the credit bureaus to start the screening process. For example, duplicate records are normally deleted, and the lists may be scrubbed against several files, including, but not limited to, the:

- Existing customer base to drop names of existing customers if a multiple account strategy is not involved.
- Do-not-solicit file to eliminate the names of consumers who have opted out of receiving solicitations.
- Prison address files to limit instances of issuing cards to incarcerated individuals.
- Charge-off files to avoid marketing to consumers with non-ledger debt at the bank.

The scrubbing process helps the bank with limiting costs and potentially employing an efficient and effective marketing campaign. Scrubbing processes are used for certain application strategies, as well. For example, for lists of names from a third party (such as a college or association), the bank may scrub the list prior to sending out invitations-to-apply (ITAs) in order to not market to existing customers. Application strategies are discussed later in this chapter.

Following pre-bureau processing, the screening of prospects begins at the bureau level. Even though the bank may submit names and addresses to the bureaus if using internally-generated or acquired lists, the screening results initially provided to the bank from the bureau only include data on the pool, not identifying consumer information. This process ensures that, at this stage, the bank cannot identify which consumers from the lists submitted to the bureaus met the screening criteria or did not meet the criteria.

For populations to be drawn from a general credit bureau search (rather than a list), the credit bureau's data base is searched to determine which consumers meet the screening criteria (and are not on the bureau's do-not-solicit file). Scrubbing qualifications similar to those used in pre-bureau processing for purchased lists are generally incorporated into the search criteria.

The screening process usually yields two separate files. One file includes data (but not identifying consumer information) on the pool to which the bank might offer credit, or the inclusion list; the other identifies the group to which it will not extend credit, or the exclusion list. The exclusion population includes records matching the scrubbing criteria provided, and, therefore, represents those records that will not be considered further for the current credit offer.

The group on the inclusion list undergoes scoring. It is segmented into various levels based on credit criteria, often including credit bureau scores. For example, the levels may be designated as “A,” “B,” and “C” with level “A” consumers exhibiting higher credit scores and lower credit risk while level “B” and “C” consumers would have lower credit scores and exhibit higher credit risk. Certain other predictors, such as risk scores, can be considered and appended to the data. For more information on scoring, refer to the Scoring and Modeling chapter.

By segmenting the group, management is able to select the risk profile it desires and offer a variety of prices and products. For example, segmentation can help banks finalize their credit line assignment criteria. Some banks assign the credit line up front and disclose the line to the consumer as part of the pre-approved offer. Other banks offer the consumer a credit limit up to a maximum amount in the solicitation, and then assign the credit line after the consumer responds. “Up to” campaigns in and of themselves are not contrary to law. They may, however, warrant criticism if not properly administered (for example, when the maximum credit line offered is rarely assigned). Examiners should closely review the bank’s use of “up to” marketing campaigns, including reviewing the marketing materials and reports on lines assigned. In addition to incorporating findings into the risk management examination process, examiners should consult with their compliance counterparts regarding programs of potential concern. Credit line assignments and management are discussed in the Underwriting and Loan Approval chapter as well as the Portfolio Management chapter.

The feedback (or the data and files that are assembled by the bureaus) that has been provided to the bank thus far in the process and that has been used to help it select the desired risk profile still does not include identifying consumer information. Identifying information is explicitly excluded in order to avoid triggering provisions of the Fair Credit Reporting Act (FCRA). As such, management is able to analyze the scoring distributions of the inclusion group as well as the size of the population and refine the marketing campaign to fits its needs. For example, the score distributions can be tightened and the population can be reduced.

Once management has refined the campaign and is comfortable with screening results (including ensuring that those results accurately reflect the criteria provided to the bureaus and list providers), it takes delivery of a list which includes identifying information. That identifying information includes the name and address of the consumer, an identifier that is not unique to the consumer and that is used by the bank solely for the purpose of verifying the identity of the consumer, and other information that does not identify the relationship or experience of the consumer with respect to a particular creditor or other entity. In accordance with the FCRA, firm offers of credit must be made to the consumers on the list. The only scrubbing-type processes that may occur once the bank gets this identifying information would be those consistent with the permissible purpose guidelines set forth in the FCRA. Keeping the length of time minimal between receiving the list and soliciting the consumer helps ensure that credit is extended only to desired risk profile. Employing a deadline for offer acceptance also helps in that respect as well as in respect to liquidity planning.

Application Strategies

Application strategies vary between banks depending on size and marketing strategy. These strategies are largely overshadowed by the pre-approved solicitation strategy but remain an effective method for reaching some market niches. Credit card application strategies can include, but are not limited to, telemarketing, direct mailings, print ads, take one applications, and internet. For example, a bank might mail ITAs to consumers who are on a certain list (like a list of customers for a certain retail establishment). In these cases, the bank's selection processes have not gone to the level of pre-approval. However, they may have included scrubbing processes, such as to eliminate mailings to existing customers or to consumers on the do-not-solicit list. The consumer completes the application, and the bank then determines whether or not credit will be extended, which frequently incorporates reviewing the consumer's **credit report**, including the consumer's credit score.

Portfolio Purchases

Portfolio acquisition is the purchase of all or part of a credit card portfolio from another entity. Banks often purchase portfolios to rapidly expand an existing credit card operation, realize the advantages of economies of scale, or diversify product lines or geographic markets. In addition, the cost to purchase a portfolio may be significantly lower than other acquisition methods. Saturation in the industry also makes this method attractive to banks. General information about portfolio purchases is found in the Purchased Portfolios and Relationships chapter.

FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003 (FACT ACT)

The FACT Act was established December 4, 2003, and amends the FCRA. There are provisions that do and will impact marketing, including those regarding use of affiliate-shared information and enhanced disclosure of opt-out means. Examiners should be cognizant of FCRA and FACT Act provisions and should consult with their compliance counterparts if they observe any potential concerns regarding a bank's compliance with the regulations' provisions.

The FACT Act amended the FCRA in part to enhance disclosure of the means available to consumers to opt out of pre-screened lists and thus allows consumers greater control regarding the type and number of marketing solicitations that they receive. Section 615 of the FCRA requires that certain statements be provided with each written pre-screened offer and is amended by Section 213 of the FACT Act. The amendment requires that the mandated statement be simple and easy to understand and, in effect, gives consumers better access to information about how to opt-out of pre-screened lists at **consumer reporting agencies**.

Affiliate marketing provisions were amended by section 214 of the FACT Act and are covered in Section 624 of the FCRA. That section requires consumers to be provided with a notice and an opportunity to opt out of an entity's use of certain information received from an affiliate to make solicitations to the consumer. The opt-out right differs from restrictions in the Gramm-Leach-Bliley Act (GLBA) and in other FCRA provisions because it is tied to use of the shared information rather than to the sharing of the information. The federal banking agencies along with other applicable agencies are developing final regulations to implement the opt-out requirement. Banks are not subject to the requirements until the final rules are implemented and effective. Therefore, examiners (as well as bank management) must remain abreast of new and ever-changing industry guidelines.

BALANCE TRANSFER AND PROMOTIONAL RATE MARKETING

Promotional rate marketing attracts new customers and/or induces new and existing customers to transfer balances by offering a reduced interest rate for a limited time on certain charges and transactions. The reduced rate is also often subject to other material limitations. Without adequate controls, promotional rates may disguise a borrower's repayment capacity when qualification is based on the reduced rate rather than the re-set rate. In addition, higher **attrition** may occur when promotional rates expire. Like "up to" marketing, promotional rate marketing in and of itself is not contrary to law, but, if not administered properly, can warrant criticism. For example, the lack of full and prominent disclosure of material limitations or applicable fees may be problematic. Examiners should closely review promotional rate marketing programs and consult with their compliance counterparts if concerns are identified.

Banks often offer a **balance transfer** option as part of a pre-approved or application strategy and often in conjunction with promotional rate marketing. With a balance transfer, a consumer transfers all or a portion of their credit card debt with other entities onto the credit card extended by the bank. The consumer is often enticed to transfer the balances by receiving a lower interest rate than what they might have on their existing accounts. The characteristics of the debt transferred can vary depending on the bank's program. For example, some banks offer to take transfers of bad debt. Balance transfer strategies can result in rapid growth of receivables, and as such, should be carefully monitored and managed. For example, rapid growth could exceed the level of available funding capacity. Furthermore, the immediate booking of relatively large balances can distort performance ratios. Profitability can also be easily impacted depending on consumer behavior. For example, some consumers pay off the balance or move the balance to yet another card before or at the time the promotional rate on the existing card expires. The cycle may occur over and over, with the consumer able to take advantage of extremely low interest rates for an extended period of time. Promotional rate and balance transfer marketing are responsible for some degree of customer loyalty erosion that has occurred in the industry.

CREDIT AVAILABILITY AND CARD UTILITY

Compliance, credit, reputation, and other risks may arise depending on a cardholder's credit availability and **card utility** at account opening. There are credit card products in which significant fees or other items are immediately charged by the bank to the card, sometimes approaching the nominal credit line, which result in the consumer having little available credit or card utility. In addition to complying with technical disclosure and other requirements, issuers of these types of products are expected to carefully ensure that their marketing solicitations, disclosures, and other materials do not violate prohibitions against unfair or deceptive practices. In general, expectations are that all marketing and other materials contain prominent, readily understandable disclosures of the material costs, risks, terms, and other characteristics, including conditions and limitations, of the product offered. Some banks have been required to discontinue certain programs based on concerns about available credit and card utility and have incurred significant financial penalties for improperly administering and managing such programs.

ADVERSE SELECTION

Within any population of potential customers there is an expected number of bad credit risks. Adverse selection occurs when a disproportionate number of bad credit risks respond to an offer and fewer than expected good risks respond. Contributing factors can include using non-current information in the analysis or lacking a full understanding of the market. Marketing to respondents above management's prescribed cut-off score does not ensure satisfactory asset quality and an adequate distribution across the range of acceptable scores is generally preferred. A concentration of respondents with scores at the low end of the range is an indication of adverse selection and normally results in higher levels of delinquencies and charge-offs than anticipated. Adverse selection might result in a product that is offered at a price that does not cover the potential risk for a given market and may also result in greater-than-anticipated loss rates.

Combating adverse selection begins with an effective marketing campaign. Good credits tend to selectively respond to credit offers, while bad credits tend to be less selective. Attracting good accounts is increasingly difficult due to the intense competition in the industry. But, tightly defined marketing and segmentation strategies may effectively reduce adverse selection.

Once a pre-screened solicitation is mailed, management's options are reduced. Credit generally must be granted, except under very limited circumstances, as discussed in the Underwriting and Loan Approval chapter. Portfolio analysis and account management techniques, however, can be employed to minimize losses. Post-screening is a valuable tool. An increase in the number of respondents with large decreases in credit scores between pre-screening and post-screening is a symptom of adverse selection. If adverse selection is detected, management may be able to take actions, such as reducing the size of credit lines being granted or limiting cash advances, to reduce exposure. Post-screening is discussed in the Underwriting and Loan Approval Process chapter. Tracking is useful in both the short and long run. In the short run, tracking, like post-screening, can help determine whether adverse selection is occurring. Once alerted, management can respond accordingly. In the long run, the information gained from tracking improves management's understanding of the market segments. This understanding assists management in developing marketing strategies and products that are attractive to the best prospects in those segments and in limiting adverse selection.

PRODUCT DIFFERENTIATION

In light of marketplace challenges to attain accounts, successful issuers continually find ways to differentiate their products to attract consumers. Product differentiation often involves value-added features. One example of a value-added product is a reward card. Reward cards include, but are not limited to, those cards that offer cash rebates, airline miles, and points toward a variety of items and services. Some rebates are even automatically contributed to pay down a cardholder's mortgage or build a savings plan. A value-added feature marketed on some subprime accounts is the potential for the consumer to mend his or her credit and/or increase his or her credit score.

Banks also attempt to differentiate their products with creative pricing. For example, the promotional rate marketing programs (sometimes known as **teaser rate** programs) are designed specifically to draw in consumers with attractive, low rates. In other cases, card products reflect variations in pricing terminology, such that the terminology differentiates the product in the consumer's view even though actual pricing might be similar or the same. Take, for example, a small subprime credit card product that involves front loading $175 of fees to the card. Some issuers might market the $175 as a lump-sum fee while others might parcel the fees, such as by marketing them as a $99 acceptance fee, a $49 set up fee, and a $27 annual fee. While they result in the same initial charge, some consumers may view the products very differently.

Examiners should gain an understanding of the features of the bank's credit card products. An understanding of the features will help examiners to better assess the bank's risk management practices and will also help in reviewing certain component areas, such as earnings. Examiners should also look for evidence to substantiate credit-repair or similar claims made.

TESTING

Testing changes in credit standards or marketing practices before full roll of such changes is necessary for an account acquisition program to remain effective. In addition to requirements for analysis, review, and decision making, examiners should expect that a bank's testing program have defined objectives. Management may employ an assortment of tests to evaluate variables such as, but not limited to, changes in cut-off scores, pricing, or product type. Key concerns with new product offerings or marketing changes include the amount of historical or test sample data available, the speed with which the product or change is introduced, and the size of the solicitations or test cells. It normally takes several months or even a year or more before bank management can draw a valid conclusion. The necessary duration of the test can vary, but when tests involve a significant departure from existing practices, the duration of the test should normally be longer than in other cases. In addition, the testing period should endure through the point of historical peak losses for a particular population and should allow for the proper work-through of any operational or other issues.

To carry out testing functions, management often runs **champion/challenger strategies** which involve applying one strategy (a champion) against a portion of the population and applying other strategies (challengers) against other smaller segments of the population. The goal is to identify more successful and effective practices. When a challenger proves more effective than the champion in meeting the identified objectives, management usually substitutes the challenger for the champion in the future. Champion/challenger strategies are used not only in the marketing function, but in various other risk management functions as well. Examiners should assess whether management adequately tests challengers and thoroughly weighs the costs/benefits before implementing them as champions. The following features generally describe what to look for in an adequate test:

- Covers a sufficient timeframe.
- Consists of a population large enough to make the results meaningful.
- Is well-documented.
- Includes clear descriptions of test objectives and the method(s) used.
- Considers risk and return objectives as well as credit performance hurdles and other key performance measurements.
- Considers the impact of circumstances or assumptions that may not necessarily be specific to the test or the test population, such as economic changes, natural disasters, or legal/regulatory changes.
- Is properly approved.
- Includes a strong test and control discipline that includes a clean hold-out group and test groups that are not subject to other initiatives that could influence the outcome.

MARKETING INDICES

Management's responsibility is to demonstrate their ability to successfully manage marketing operations through reliable projections and market analysis, all within the confines of controlling credit risk and remaining compliant with laws, regulations, and other guidance. Management closely monitors a variety of marketing indices, including the response rate and the costs of solicitations. The response rate is the number of applications received to total solicitations. The higher the response rate, the lower the origination cost per account. Marketing costs can fluctuate significantly depending on the size of the solicitation and the channel used, among other things. As such, marketing costs are tracked in detail. For example, management normally tabulates and tracks the cost per piece to prepare and mail each offer.

SEGMENTATION METHODS

Segmentation is the process of dividing a group into homogenous populations. A wide variety of features can be used as the basis. Examiners should evaluate how management determines its information needs and identifies and selects the segmentation basis that satisfies those needs. Typically, trends monitored by segment include delinquencies, bankruptcies, losses, **utilization** rates, attrition rates, payment patterns, and credit bureau and/or **behavior scores**. Trend analysis not only aids in the development and/or refinement of future marketing strategies, but of asset management strategies as well. Potential segmentation methods include, but are not limited to, the following:

Product Line

Segmentation by product line focuses on the type of card product offered. Product types such as affinity, co-branded, premium, and standard cards are targeted at different populations and use different selection criteria. Management may segment on this basis to help monitor historical and current trends, adjust marketing strategies, and set interest rates and fees on future products.

Geographic Location

Segmentation by geographic location captures regional differences in card usage and monitors local economic conditions. Not only does geographic segmentation better enable management to concentrate collection efforts on particular hot spots across the country, but it also allows management to adjust marketing strategies for areas with deteriorating economic trends. The importance of geographic segmentation was emphasized when banks across the country had to deal with the impacts of Hurricane Katrina on their cardholders and card portfolios.

Vintage

Risk management often monitors solicitation programs by **vintage**. Segmentation by vintage tracks the performance of accounts established at a similar time using the same credit and pricing criteria and is relevant because the performance of vintages changes over time. For example, the delinquency rate for accounts established three months ago can be compared with more seasoned accounts when they were at the 3-month vintage. This comparison allows management to more accurately assess the quality of newer accounts and monitor changes in the shape of the **loss seasoning curves** between vintages. Credit card receivables often follow fairly predictable seasoning curves in which delinquency and loss rates are typically very low for new accounts for the first few or several months, then rise significantly, and eventually level off and follow a fairly predicable pattern. Vintage analysis helps identify where a portfolio segment is at along the seasoning curve and can assist management in predicting future performance.

Vintage reports are normally generated monthly to enable management to better identify and act on developing trends in various performance characteristics such as delinquencies, bankruptcies, losses, utilization rates, attrition rates, or behavior score distributions. Initial vintage reports are limited because sufficient time has not passed to establish performance patterns and may only include the quality and quantity of the respondents, and whether the marketing campaign attracted the desired consumers. Vintage analysis reports are used to determine if actual portfolio performance has met management's projected performance.

Acquisition Method and Marketing Channel Method

Segmentation by the acquisition method separates accounts based on how they were acquired, and segmentation by the marketing channel method separates accounts based on the type of channel utilized. Institutions typically segment by these methods to better evaluate and monitor the success of the pre-approved solicitation, application, or purchased programs or to better evaluate and monitor the success of the marketing channels used.

The characteristics of the respondents to each of the bank's solicitations normally varies as a result of a number of factors such as the characteristics of the targeted population, the demographics of the respondents, the level of the cut-off scores, or the stringency of credit standards. Examiners should ascertain whether management understands who is responding to solicitations, why the responders are attracted to particular offers, and how various response patterns are affecting the bank's asset quality.

Review by solicitation allows for more precise identification of the cause of asset quality problems. For example, delinquencies and losses may primarily reflect a poorly designed solicitation offer and be centered in one portfolio, or they may reflect general economic conditions and be spread across all portfolios. Review by solicitation also aids in refining future strategies. Review of the score distribution and delinquency rates demonstrates whether desired markets were reached and aids in evaluating the effectiveness of a solicitation strategy.

Management segments by application type to assist in monitoring historical and current trends, adjusting application strategies, and setting interest rates and fees on future products.

Management typically monitors purchased portfolios to track current performance and to evaluate that performance against past trends. Monitoring may include tracking utilization rates, purchase volume, average outstanding balance per account, delinquencies, charge offs, and other items.

Other Methods and Combinations

Management can also use other segmentation methods, such as scoring. It often uses more than one segmentation method in its risk management processes and frequently uses combinations of segmentation methods to further delineate a population. For example, management might segment via product line and then further segment a product line by marketing channel. Examiners should ascertain whether the segmentation methods used are sufficient to provide valuable and effective insight as to the successfulness of the marketing program. Segmentation is also discussed in other chapters of this manual, including the Portfolio Management, Capital, and Reserving for Loan Losses chapters.

SUMMARY OF EXAMINATION GOALS – MARKETING AND ACQUISITION

Examiners are tasked with assessing whether marketing activities are consistent with the bank's business and strategic plans and risk tolerance objectives. They are to determine whether proper controls and systems were in place before the bank rolled out new marketing or account acquisition strategies and should consider reviewing items such as, but not necessarily limited to:

- The structure of the marketing department and the expertise of its staff.
- Applicable board and committee minutes (coordinated with the examiner-in-charge).
- Marketing policies and procedures.
- The marketing plan.
- The types of marketing channels used.
- Audits or other reviews of the marketing function.
- Marketing materials and cardholder agreements.
- Testing and roll-out processes for new products, marketing campaigns, or other significant initiatives.
- The chronology and composition of marketing campaigns (often maintained in a chronology log).
- Controls for affinity, co-branding, and other third-party relationships.
- Management reporting, tracking, and monitoring including department statistics, portfolio statistics, and other segmentation statistics.
- Planned product offerings or marketing changes.
- Management's identification of and response to adverse trends in the marketing area.
- Documentation substantiating unusual, sensitive, or potentially over-zealous marketing claims.
- Findings of other regulatory reviews of marketing (for example, compliance reviews).

The following items might signal current or future elevated risk and warrant additional follow-up:

- Extremely low or high response rates.
- Significant changes or swings in marketing volumes and/or channels.
- A high or increasing volume of consumer complaints regarding marketing practices.
- Significant audit or prior examination findings.
- Lack of sufficient management response to adverse trends or audit and prior examination findings.
- Absence of written policies and procedures.

These lists are not exhaustive, and examiners must exercise discretion in determining the expanse and depth of examination procedures to apply. If they identify significant concerns, they should expand procedures accordingly.

VI. PURCHASED PORTFOLIOS AND RELATIONSHIPS

Intense competition in the credit card industry is often accompanied by high costs to originate new card accounts. As a result, some banks find it more profitable to purchase credit card portfolios. In addition, some banks buy card portfolios to utilize excess servicing capacity, swiftly grow receivable holdings, or diversify assets. Rapid receivable growth could stress the bank if it is not able to properly manage the additional volume of and/or risks of the receivables taken on. Excessive amounts paid for portfolios (as a result of overvaluation) could result in necessary write-downs, and changes in the purchased portfolio's cash flow drivers after acquisition could necessitate write-downs of intangible assets booked in connection with the purchases.

PORTFOLIO ACQUISITIONS

Examiners should expect that banks that purchase portfolios have strong, well-defined policies and practices regarding portfolio acquisitions. Each prospective portfolio must be properly assessed and valued. This normally includes thorough, well-documented due diligence processes by management as well as portfolio performance and profitability analyses. Management is expected to fully understand the credit risks that it would assume if it purchases the portfolio as well as understand the seller's operations to ensure that the bank will be able to reasonably integrate the prospective portfolio into its own operations. Examiners should look for evidence that each decision to purchase, including the purchase price, took into account the effect the purchased portfolio would have on the bank's overall risk profile. Failure by management to properly exercise its responsibilities could result in the bank purchasing portfolios that are of a lesser credit quality than it desires and consequently that it may be not able to control. Cardholder performance that is unfavorable compared to what was anticipated at the time of purchase could lead to increased servicing and collection costs as well as higher credit losses than planned. As a result, asset quality, earnings, liquidity, and ultimately capital could be adversely affected. Furthermore, an unplanned need to direct management's attention to increased oversight of the portfolio could have the potential to spread management's resources too thin and consequently adversely impact oversight of the bank's other activities.

If subprime loans have been purchased, examiners should confirm whether management followed the March 1, 1999 *Interagency Guidance on Subprime Lending*. According to that guidance, banks that purchase subprime loans must give due consideration to the cost of servicing the subprime assets and to the loan losses that may be experienced, which are typically much higher than those for prime portfolios. Some lenders who sell subprime loans charge borrowers high up-front fees that are frequently financed into the loan. As such and to the detriment of a potential purchaser, originators could be inclined to produce a high volume of loans with little emphasis on quality. Further, subprime loans, especially from outside the bank's typical lending area, could carry special risk for fraud or misrepresentation (that is, the quality of the loan may be less than loan documents indicate). Examiners should look for evidence that management performed a thorough due diligence review prior to committing to purchase subprime credit card loans and normally only accepts credit card loans that meet the bank's underwriting criteria.

Whether the purchased loans are prime or subprime, marked deterioration in their quality or performance compared to the quality or performance expected points to the need for a thorough reevaluation by management of the originators, as well as re-evaluation of the bank's criteria for assessing prospective loan purchases and selecting originators (sellers). It might also highlight a need to modify or terminate the relationship with the seller or make adjustments to underwriting and originator selection criteria.

A variety of factors impacts a portfolio's cash flows and, thus, can help determine its purchase price. In general, factors include the portfolio's yield, attrition rates, charge-off rates, funding rates, fee income, and processing costs. Most banks that purchase credit card portfolios maintain automated software models that management loads with portfolio performance estimates. Models typically generate a host of information that can help the purchaser determine whether it should purchase the portfolio and what an appropriate value for the portfolio would be.

PURCHASED CREDIT CARD RELATIONSHIPS

Examiners should verify that management carefully and thoroughly assesses intangible assets recognized in connection with the acquisition of card portfolios. These intangible assets are commonly known as purchased credit card relationships (PCCRs). PCCRs represent the right to conduct ongoing credit card business dealings with the cardholders and normally are recorded as assets when a bank purchases existing credit card receivables at a premium and has the right to provide card services to the cardholders whose credit card accounts have been purchased. PCCRs may also be acquired when a bank purchases an entity that owns a credit card portfolio.

Banks can continue to reflect PCCRs for purchased portfolios that are securitized. This conclusion is based on the continuation of account ownership by the bank and the inherent value in the cardholder relationship.

ACCOUNTING

All assets acquired and liabilities incurred in a portfolio purchase are normally recognized and measured at fair value. When quoted market prices are not available, fair value is estimated based on the best information available in the circumstances. The fair value methodology considers prices for similar assets and liabilities and the results of valuation techniques to the extent available. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. In addition to being consistent with the objective of measuring fair value, techniques should be designed to incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, defaults, payments, and volatility. When used to estimate fair value, estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections and should consider all available evidence.

The premium (difference between the amount paid and the sum of balances of the credit card loans purchased) should be allocated between the cardholder relationships acquired (that is, the PCCRs) and the loans acquired. The premium allocated to the loans acquired should be amortized over the life of the loans in accordance with FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. After this initial allocation, the PCCRs are carried at amortized cost.

In July 2001, FAS 141, *Business Combinations*, and FAS 142, *Goodwill and Other Intangible Assets,* were issued. FAS 141 requires that intangible assets acquired in a business combination be recognized as assets apart from goodwill if they meet one of two criteria: the contractual-legal criterion or the separability criterion. If an entity establishes relationships with its customers through contracts, such as cardholder agreements, those customer relationships would arise from contractual rights. Thus, customer contracts and the related customer relationships are intangible assets that meet the contractual-legal criterion. The amount to be assigned to PCCRs at acquisition in a business combination is the estimated fair value. FAS 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon acquisition. Upon acquisition, these intangible assets are to be initially recognized and measured based on fair value.

Subsequent to acquisition, PCCRs acquired in a business combination individually, or with a group of other assets, are to be accounted for in accordance with FAS 142. This is because the nature of an asset, not the manner of its acquisition, determines subsequent accounting for the asset. According to FAS 142, those intangible assets that are not deemed to have an indefinite life (rather, they have a finite life), such as PCCRs, are to be amortized over their useful lives.

The estimate of the useful life of an intangible asset is to be based on an analysis of all pertinent factors such as the entity's expected use of the asset and any legal, regulatory, or contractual provisions limiting its useful life. Examiners should verify that PCCRs are being amortized using a method that reflects the pattern in which the economic benefits of the intangible assets are consumed. For PCCRs, these benefits are consumed as the revenue stream generated by the cardholder relationships is realized. Because the revenue stream normally declines each year after purchase, use of an accelerated method of amortization based on the estimated attrition rate of the purchased credit card accounts generally results. If a usage pattern cannot be reliably determined, which is unlikely to be the case for PCCRs, the straight-line method must be used. The estimated useful life of PCCRs most often does not exceed 10 years. However, in rare cases, a longer useful life and amortization period may be justified. Cases where support for the estimated useful life applied is not adequate or well-documented generally cause concern.

Examiners should look for evidence that management performs a quarterly evaluation of the PCCRs, including documentation thereof, and adjusts the carrying value as necessary. They should determine whether management properly considers unanticipated acceleration or deceleration of cardholder payments, account attrition, changes in fees or finance charges, or other events or changes in conditions that may point to the carrying amount of the PCCRs not being recoverable. If the carrying amount might not be recoverable, examiners should verify that management tests the PCCRs for recoverability and, if not recoverable, recognizes any impairment loss in accordance with FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The carrying amount is not recoverable if it exceeds the sum of the undiscounted expected future cash flows from the intangible asset. The PCCRs would then be written down to their fair value (e.g., the present value of estimated future cash flows from the intangible asset).

As of October 1, 2002, FAS 144 applies to long-term customer-relationship intangible assets such as PCCRs that are recognized in the acquisition of a financial institution (as set forth in paragraph 6 of FAS 147, *Acquisitions of Certain Financial Institutions*). According to FAS 147, those intangibles, which include those acquired in transactions between two or more mutual enterprises, are subject to the same undiscounted cash flow recoverability test and impairment loss recognition and measurement provisions that FAS 144 requires for other long-lived assets that are held and used.

Examination of PCCRs normally requires the examiner to review management's original acquisition model, the quarterly cash flow and fair value models, and related data that support management's assumptions. The supporting documentation is the basis which determines the proper amount of PCCRs that should be included in regulatory capital.

CAPITAL LIMITATIONS FOR PCCRs

PCCRs are one of only a few intangible assets that are not deducted from Tier 1 capital, subject to certain limitations. A deduction of all or a part of the PCCRs may be required if the carrying amount is excessive in relation to their market value or the level of the bank's capital accounts. Consequently, PCCRs will be recognized for regulatory capital purposes only to the extent they meet the conditions, limitations, and restrictions described in Section 325.5(f) of the FDIC's Rules and Regulations. Examiners should refer to Part 325 – Capital Maintenance for details. In summary, for purposes of determining Tier 1 capital, PCCRs will be deducted from assets and from equity capital to the extent that they do not meet the following conditions, limitations, and restrictions: valuation requirements; fair value limitation; Tier 1 capital limitation; and Tier 1 capital sub-limit, each of which is discussed on the next page.

Valuation Requirements

The fair value must be estimated at least quarterly and shall include any adjustments for any significant changes in the original valuation assumptions, including changes in payment estimates or attrition rates. The FDIC has the discretion to require independent fair value estimates on a case-by-case basis when deemed appropriate for safety and soundness reasons.

Fair Value Limitation

For calculating Tier 1 capital, but not for financial statement purposes, mortgage servicing assets (MSAs), PCCRs, and non-mortgage servicing assets (NMSAs) are each to be reduced to an amount equal to the lesser of:

- 90 percent of the fair value of these assets; or
- 100 percent of the remaining unamortized book value of these assets (net of any valuation allowances), as determined according to Call Report instructions.

Tier 1 Capital Limitation

The maximum allowable amount of MSAs, PCCRs, and NMSAs in the aggregate is the lesser of:

- 100 percent of the amount of Tier 1 capital that exists before deduction of any non-financial equity investments or any disallowed:
    - MSAs.
    - PCCRs.
    - NMSAs.
    - Credit-enhancing IO strips.
    - Deferred tax assets; or
- The sum of the amounts of MSAs, PCCRs, and NMSAs determined in accordance with the fair value limitations.

Tier 1 Capital Sub-limit

In addition to the aggregate limit placed on MSAs, PCCRs, and NMSAs as described in the Tier 1 Capital Limitation section, a sub-limit applies to PCCRs and NMSAs in the aggregate. The maximum allowable amount is limited to the lesser of:

- 25 percent of the amount of Tier 1 Capital that exists before the deduction of any non-financial equity investments or any disallowed:
    - MSAs.
    - PCCRs.
    - NMSAs.
    - Credit-enhancing IO strips.
    - Deferred tax assets; or
- The sum of PCCRs and NMSAs determined as described in the Fair Value Limitation section.

LOAN LOSS ALLOWANCES FOR PURCHASED PORTFOLIOS

Under current accounting practices, banks typically book an increase in their loan loss allowance as part of their entries to record the purchase of a credit card portfolio. This increase in the allowance occurs without the recording of an income statement entry for a loan loss provision. In some cases, this has resulted in the credit card receivables being recorded at a premium, which must be amortized as an adjustment to the yield of the purchased portfolio over the life of the loans in accordance with FAS 91.

In general, when a bank purchases a credit card portfolio, including a portfolio acquired in a business combination, the portion of the allowance for loan and lease losses (ALLL) on the seller's balance sheet that relates directly to, or has been allocated to, the purchased portfolio is carried over and recorded as an increase in the purchaser's ALLL at the time of acquisition. However, as discussed below, if any of the acquired credit card receivables fall within the scope of AICPA Statement of Position 03-03, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3), an adjustment must be made to the portion of the seller's ALLL that is carried over to the purchaser's books. Other adjustments to the portion of the seller's ALLL that the purchaser carries over generally are not appropriate, except in the limited circumstances discussed in the Securities and Exchange Commission's (SEC) Staff Accounting Bulletin No. 61, *Adjustments to Allowances for Loan Losses in Connection with Business Combinations* (Codified in Topic 2.A.5 in the SEC's Codification of Staff Accounting Bulletins). Under all circumstances, management should provide adequate documentation to support the amount of the allowance that is carried over as an increase in the purchasing bank's ALLL and a means by which it can be verified objectively.

SOP 03-3 prohibits a bank from carrying over or creating loan loss allowances in the initial accounting for purchased **impaired** loans (i.e., loans that a bank has purchased where there is evidence of deterioration of credit quality since the origination of the loan and it is probable, at the purchase date, that the bank will be unable to collect all contractually required payments receivable). This prohibition applies to the purchase of an individual impaired loan, a pool or group of impaired loans, and impaired loans acquired in a purchase business combination.

With respect to credit card receivables, SOP 03-3 provides that accounts of cardholders who have "revolving privileges," i.e., can continue to use the credit card for purchases and cash advances, are not to be treated as purchased impaired loans. Although the credit card receivables of cardholders whose revolving privileges have been revoked must be individually evaluated to determine whether they meet the criteria for being treated as a purchased impaired loan under SOP 03-3, such receivables will normally meet these criteria. The bank that purchases these impaired credit card receivables must determine the amount of the seller's ALLL allocated to the entire purchased portfolio that should be attributed to the impaired receivables because this amount may not be carried over to the purchaser's ALLL. If the seller had not specifically attributed a portion of its ALLL to the credit card receivables for which the cardholders' revolving privileges had been revoked, the purchaser should consider the fact that such receivables likely have additional risk characteristics compared to the credit card accounts that have revolving privileges. As a consequence, within the seller's ALLL allocated to the entire purchased portfolio, the amount attributable to the receivables of cardholders whose revolving privileges had been revoked would be expected to be a larger percentage of the seller's ALLL than simply the percentage of purchased impaired receivables in the purchased portfolio. Thus, management should maintain adequate documentation to support its determination of the estimated amount of the seller's allowance attributable to purchased impaired credit card receivables that cannot be carried over under SOP 03-3.

Subsequent to the acquisition of purchased impaired credit card receivables accounted for in accordance with SOP 03-3, the purchaser must continue to evaluate the cash flows expected to be collected on these receivables. If, upon such a subsequent evaluation, management determines, based on current information and events, that it is probable that the bank will be unable to collect all cash flows expected at acquisition (plus additional cash flows expected to be collected arising from changes in estimate after acquisition) on a purchased impaired credit card receivable, the receivable should be considered impaired for purposes of establishing an allowance pursuant to FAS 5 or 114, as appropriate.

Loan loss allowances for credit card portfolios are discussed in the Allowances for Loan Losses chapter.

SUMMARY OF EXAMINATION GOALS – PURCHASED PORTFOLIOS AND RELATIONSHIPS

The examiner's role generally includes the following activities:

- Determining whether the bank has purchased any credit card portfolios.
- Determining if the bank has booked any PCCRs.
- Assessing the bank's policies governing portfolio purchases and PCCRs, including any accounting policies.
- Reviewing the original acquisition model.
- Evaluating management's most recent quarterly fair value estimate to determine the eligible amount of PCCRs for regulatory capital. Also, deciding the following:
    - Whether the discount rate used in the determination of fair value is appropriate.
    - Whether the time period used in the cash flow models and the amortization period and methods are appropriate for the PCCRs associated with each segment in the purchased portfolio.
- Reviewing the amount of any ALLL carried over in connection with the purchase of a credit card portfolio to determine that it does not exceed the amount allocated to the sold portion of the portfolio on the seller's balance sheet, adjusted for the amount of the seller's ALLL attributable to purchased impaired credit card receivables.

Examiners should consult with accounting specialists as necessary.

VII. UNDERWRITING AND LOAN APPROVAL PROCESS

Underwriting is the process by which the lender decides whether an applicant is creditworthy and should receive a loan. An effective underwriting and loan approval process is a key predecessor to favorable portfolio quality, and a main task of the function is to avoid as many undue risks as possible. When credit card loans are underwritten with sensible, well-defined credit principals, sound credit quality is much more likely to prevail.

GENERAL UNDERWRITING CONSIDERATIONS

To be effective, the underwriting and loan approval process should establish minimum requirements for information and analysis upon which the credit is to be based. It is through those minimum requirements that management steers lending decisions toward planned strategic objectives and maintains desired levels of risk within the card portfolio. Underwriting standards should not only result in individual credit card loans with acceptable risks but should also result in an acceptable risk level on a collective basis. Examiners should evaluate whether the bank's credit card underwriting standards are appropriate for the risk-bearing capacity of the bank, including any board-established tolerances.

Management essentially launches the underwriting process when it identifies its strategic plan and subsequently establishes the credit criteria and the general exclusion criteria for consumer solicitations. Procedures for eliminating prospects from solicitation lists and certain screening processes could also be considered initial stages of the underwriting and loan approval process in that they assist in weeding out consumers that may be non-creditworthy in relation to the bank's risk tolerance level, identified target market, or product type(s) offered.

Compared to other types of lending, the underwriting and loan approval process for credit card lending is generally more streamlined. Increasingly, much of the analytical tasks of underwriting are performed by technology, such as databases and scoring systems. Whether the underwriting and loan approval process for credit cards is automated, judgmental, or a combination thereof, consistent inclusion of sufficient information to support the credit granting decision is necessary. Underwriting standards for credit cards generally include:

- Identification and assessment of the applicant's repayment willingness and capacity, including consideration of credit history and performance on past and existing obligations. While underwriting is based on payment history in most instances, there are cases, such as some application strategies, in which guidelines also consider income verification procedures. For example, assessments of income like self employment income, investment income, and bonuses might be used.
- Scorecard data.
- Collateral identification and valuation, in the case of secured credit cards.
- Consideration of the borrower's aggregate credit relationship with the bank.
- Card structure and pricing information.
- Verification procedures.

The compatibility of underwriting guidelines with the loan policy, the strategic plan, and the desired customer profile should be assessed. Examiners also determine whether such guidelines are documented, clear, and measurable, such that management can track compliance with and adherence to the guidelines. Moreover, examiners should assess management's periodic review process for ensuring that card underwriting standards appropriately preserve and strengthen the soundness and stability of the bank's financial condition and performance and are attuned with the lending environment.

In addition to the decision factors, management should also set forth guidelines for the level and type of documentation to be maintained in support of the decision factors. Records typically include, but are not limited to, the signed application, the verified identity of the borrower, and the borrower’s financial capacity (which may include the credit bureau report or score). In the case of secured cards, records to look for include a collateral evaluation and lien perfection documents. Another item of interest to review includes a method of preventing application fraud such as name and address verification, duplicate application detection, social security number verification, or verification of other application information. The verification level supported by management normally depends upon the loan’s risk profile as well as the board’s risk appetite.

The process for altering underwriting terms and standards can involve prominent decisions by management to amend policies and procedures. However, more subtle or gradual modifications to the application of the card underwriting policies and procedures can also produce changes in bank's risk profile. For instance, the bank might increase credit limits or target a higher proportion of solicitations to individuals in lower score bands without reducing the minimum credit score. Albeit less apparent, the resultant change can create significant loan problems if not properly controlled. Examiners should assess management’s records that outline underwriting changes, such as chronology logs, to determine whether the records are well-prepared and complete and to identify underwriting changes that, individually or in aggregate, may substantially impact the quality of accounts booked.

In the hyper-competitive credit card market, some banks may be inclined to relax lending terms and conditions beyond prudent bounds in attempts to obtain new customers or retain existing customers. Examiners should be sensitive to all levels of credit easing and the potential impact of the ease on the bank's risk profile. Rapid growth can, but does not necessarily, indicate a decline in underwriting standards. In addition, rising loss rates may indicate a weakening of underwriting criteria. Examiners should also consider that the bank’s appetite for risk often involves balancing underwriting and the pricing structure to achieve desired results. Thus, management may have priced the products to sufficiently compensate for the increased risk involved in easing credit standards. Take, for example, subprime loans which typically exhibit higher loss rates. They can be profitable, provided the price charged is sufficient to cover higher loss rates and overhead costs related to underwriting, servicing, and collecting the loans. Examiners should sample management’s documentation that supports credit decisions made. Management’s documentation might include the contribution to the net interest margin and noninterest income in relation to historical delinquencies and charge-offs compared to other types of card programs. When relaxed credit underwriting is identified, examiners should assess the adequacy of the total strategy.

Results of credit underwriting weaknesses are not limited to elevated credit risk. For example, the weaknesses may cause difficulties in securitization or sales of the underwritten assets, thereby elevating liquidity risk. Further, future credit enhancements and pricing for securitizations may be more costly or less readily available when poorly underwritten receivables adversely affect the bank’s reputation. In some cases, access to securitization-based funding may vanish. Impairment of a bank’s reputation as an underwriter can limit accessibility to financial markets or can raise the costs of such accessibility.

PROGRAM-SPECIFIC UNDERWRITING CONSIDERATIONS

Affinity and Co-Branding Programs

Examiners normally expect banks to refrain from materially modifying underwriting standards for affinity and co-branded card customers. Rather, credit card underwriting guidelines for partnered programs should generally be compatible with the bank’s loan policy, strategic plan, and desired customer profile. If underwriting practices diverge from the bank’s normal standards, examiners need to determine the appropriateness of program differences and the overall impact on portfolio quality. They should look for evidence that management has ensured that the eased standards still result in an acceptable level of risk and that any elevated risks are appropriately addressed.

Private Label Programs

Examiners should expect management to pay careful attention to the financial condition of the retail partner when it determines whether to offer private label cards. They also normally expect management to refrain from materially modifying underwriting standards to accommodate its retail partners. A retailer that aims to maximize the number of cards in circulation may expect the bank to lower its credit standards. If the bank lowers its credit standards, management should ensure that the standards still result in an acceptable level of risk and that any elevated risks are appropriately addressed.

Loss-sharing agreements can be an effective means to mitigate risk and give merchants reason to accept more conservative underwriting standards. With a loss-sharing agreement, either the bank's loss rate is capped at a certain percentage or the merchant covers a certain percentage of the dollar volume of losses. The retail partner's share of losses can be quite high, and the bank's role may be more similar to that of a servicer than a lender. Examiners should analyze management's practices for ensuring that the retailer has the financial capacity to cover its portion of the losses. They should also gauge management's procedures for analyzing and responding to contingencies, such as if the retailer was to file bankruptcy and the cardholders were not compelled to repay their balances.

Corporate Credit Card Programs

Corporate credit card programs may pose more commercial credit risk than consumer credit risk because the company may be primarily liable for the debt. In cases where the corporation is primarily liable for the debt, examiners should expect that management's decision to grant the line of credit is consistent with the institution's commercial loan underwriting standards. The credit granting process should also consider relationships that the company has with the bank's commercial banking department. Examiners should review the contract terms of corporate credit card programs in a manner similar to how they would review any other commercial loan file. Documentation should include management's assessment of the financial condition of the company along with its willingness to pay in a timely manner. Examiners should also ascertain whether the bank or the corporate borrower decides which company employees receive corporate cards. It the borrower decides, examiners should determine what controls the bank uses to reduce risk.

Subprime Credit Card Programs

Subprime lending is generally defined as providing credit to consumers who exhibit characteristics that suggest a much higher risk of default as compared to the risk of default with traditional bank loan customers. Examiners should evaluate whether management has carefully attended to underwriting standards for subprime credit card programs. Underwriting for subprime credit cards is usually based upon credit scores generated by sophisticated scoring models, which use a substantial number of **attributes** to determine the probability of loss for a potential borrower. Those attributes often include the frequency, severity, and recency of delinquencies and major derogatory items, such as bankruptcy. When underwriting subprime credit cards, banks generally use risk-based pricing as well as tightly controlled credit limits to mitigate the increased credit risk evident in the consumer's profile. Banks may also require full or partial collateral coverage, typically in the form of a deposit account at the bank. Credit availability and card utility concerns are other important considerations.

Home Equity Credit Card Programs

Home equity lending in general has recently seen rapid growth and eased underwriting standards. The quality of real estate secured credit card portfolios is usually subject to increased risk if interest rates rise and/or home values decline. As such, sound underwriting practices are indispensable in mitigating this risk. Examiners should look for evidence that management considers all relevant risk factors when establishing product offerings and underwriting guidelines. Generally, these factors include borrowers' income and debt levels, credit score (if obtained), and credit history, as well as loan size, collateral value (including valuation methodology), and lien position. Examiners should determine whether effective procedures and controls for support functions, such as perfecting liens, collecting outstanding loan documents, and obtaining insurance coverage, are in place.

For real estate secured programs, compliance with the following guidance is considered:

- Part 365 of the FDIC Rules and Regulations – *Real Estate Lending Standards*, including Appendix A which contains the *Interagency Guidelines for Real Estate Lending Policies*.
- *Interagency Appraisal and Evaluation Guidelines*.
- *Interagency Guidance on High Loan-to-Value Residential Real Estate Lending*.
- *Home Equity Lending Credit Risk Management Guidance* issued May 24, 2005.

Other laws, several of which are reviewed during the compliance examination, also apply.

Part 365 requires banks to maintain written real estate lending policies that are consistent with sound lending principles and appropriate for the size of the institution as well as the nature and scope of its operations. It specifically requires policies that include, but are not limited to:

- Prudent underwriting standards, including LTV limits.
- Loan administration procedures.
- Documentation, approval and reporting requirements.

Consistent with the agencies regulations on real estate lending standards, prudently underwritten home equity credit card loans should include an evaluation of a borrower's capacity to adequately service the debt. Considering the real estate product's sizable credit line typically extended, an evaluation of repayment capacity should most often consider a borrower's income and debt levels and not just the borrower's credit score. A prominent concern is that borrowers will become overextended, and the bank may have to consider foreclosure proceedings. As such, underwriting standards should emphasize the borrower's ability to service the card line from cash flow rather than the sale of the collateral. If the bank has offered a low **introductory rate**, repayment capacity should consider the rate that could be in effect at the conclusion of the introductory term.

A potentially dangerous misstep in underwriting home equity credit cards is placing undue reliance upon a property's value in lieu of an adequate initial assessment of an applicant's repayment ability. However, establishing adequate real estate collateral support in conjunction with appropriately considering the applicant's repayment ability is a sensible and necessary practice for home equity credit card lending.

Examiners should expect that management has established criteria for determining an appropriate real estate valuation methodology (for example, higher-risk accounts should be supported by more thorough valuations) and requires sufficient documentation to support the collateral valuation. Banks have streamlined real estate appraisal and evaluation processes in response to competition, cost pressures, and technological advancements. These changes, coupled with elevated LTV risk tolerances, have heightened the importance of strong collateral valuation policies and practices. The *Interagency Appraisal and Evaluation Guidelines* sets forth expectations for collateral valuation policies and procedures. Use of automated valuation models (AVMs) and other collateral valuation tools for the development of appraisals and evaluations is increasingly popular. AVMs are discussed in the Scoring and Modeling chapter.

Management is expected to establish limitations on the amount advanced in relation to the value of the collateral (LTV limits) and to take appropriate measures to safeguard its lien position. Examiners should determine whether management verifies the amount and priority of any senior liens prior to the loan closing when it calculates the LTV ratio and assesses the collateral's credit support. The *Interagency Guidelines for Real Estate Lending Policies (Appendix A to Part 365)* and the *Interagency Guidance on High LTV Residential Real Estate Lending* address LTV considerations, including supervisory LTV limitations. There are several factors besides LTV limits that influence credit quality. Therefore, credit card loans that meet the supervisory LTV limits should not automatically be considered sound, and credit card loans that exceed the supervisory LTV limits should not automatically be considered high risk. Examiners should refer to the mentioned guidance and to the Risk Management Manual of Examination Policies for LTV details, such as reporting requirements and aggregate limits in relation to capital levels.

Cash Secured Credit Card Lending

While cash secured credit card lending may be less susceptible to credit risk than other types of credit card lending, credit risk is not eliminated. The outstanding balance on an account could exceed the collateral amount either due to the account being only partially collateralized at account set-up or due to allowing the cardholder to go over-limit. Partially secured cards represent unsecured credit to higher-risk consumers to the extent that the line or balance exceeds the deposit amount. Underwriting for these types of accounts (as well as for those fully secured) should clearly substantiate the consumer's willingness and ability to service the debt.

Examiners should verify whether management has established clear underwriting policies and practices for cash secured lending. These polices should include, among other items, guidelines for credit limit assignments in relation to the amount of collateral required. Examiners should also determine management's practices for performing credit analysis on the applicant, which may include verifying the applicant's income, and for ensuring that a perfected security interest in the deposit is established and maintained. If the bank retains possession of the deposit, its security interest in the deposit is generally perfected.

Purchased Portfolios

Similar to expectations for partnership agreements (that is, co-branded and similar programs), examiners should expect that the bank refrain from materially modifying underwriting standards when it purchases portfolios of credit card receivables. If underwriting criteria are eased in comparison to the banks' internally-established underwriting criteria it could result in elevated credit risk that management would need to take appropriate action for, which may include holding higher levels of loss allowances, hiring additional collectors, and so forth. And, if the cardholder base is significantly different than that normally held by the bank, management could be at risk of not fully understanding the expectations of those cardholders, thereby raising reputation risk. Examiners should confirm whether management considers underwriting criteria used by originators in its due diligence processes for portfolio purchases. If underwriting criteria for purchased portfolios diverge from the bank's typical underwriting standards, examiners need to determine the appropriateness of the differences in relation to management's capabilities and to the overall impact on portfolio quality and the bank's risk profile. Purchased credit card portfolios are discussed in the Purchased Portfolios and Relationships chapter.

COMPARISON OF AUTOMATED AND JUDGMENTAL PROCESSES

Once a consumer completes an application, the application either is processed through an automated processing system or is processed manually, or judgmentally. Regardless of the type of process used, the audit department should examine it with any deviations communicated promptly to management.

Automated underwriting and loan approval processes are increasingly popular and vary greatly in complexity. In an automated system, credit is generally granted based on the cut-off score and the desired loss rate. These systems are often based on statistical models and apply automated decision-making where possible. Banks sometimes establish auto-decline or auto-approve ranges where the system either automatically approves or declines the applicant based on established criteria, such as scores. The automated systems may also incorporate criteria other than scores (such as rules or overlays) into the credit decision. For example, the presence of certain credit bureau attributes (such as bankruptcy) outside of the credit score itself could be a contributing factor in the decision-making process. Examiners should gauge management's practices for validating the scoring system and other set parameters within automated systems as well as for verifying the accurateness of data entry for those systems.

Judgmental underwriting processes also vary in complexity but are not as popular as they have been in the past, mainly due to advances made in automated underwriting processes. While not as popular, judgmental processes are preferred and/or necessary in some cases, such as if the bank cannot (or does not want to) pay the amount necessary to establish and maintain such systems or if the portfolio is very small and perhaps consists of the bank's traditional customers. In a judgmental process, credit is granted based on a manual review using the bank's underwriting guidelines which guide the quality of new accounts. The bank's control systems for ensuring that analysts consistently follow policy should undergo review during the examination.

When an applicant is approved or denied contrary to a system's recommendations or guidelines, it is usually called an **override**. For example, if the applicant falls outside of the auto-approval range, the applicant may be referred for manual review in certain cases. As such, the applicant may be approved despite not meeting the system's criteria, which is called a **low-side override**. And, in other cases, applicants that would be auto-approved might be referred for manual review and declined based on rules or other guidelines that management has established or authorized, which is referred to as a **high-side override**. High-side overrides generally occur when derogatory information becomes known to management.

The following types of overrides are commonly encountered:

- Informational overrides occur when information not included in the scoring process becomes known to management.
- Policy overrides occur when management establishes special rules for certain types of applications.
- Intuitional overrides occur when management makes decisions based on judgment rather than the scoring model.

Scoring is a predominant feature of most automated underwriting and loan approval processes. When scoring is used to grant credit, quality is controlled by setting the cut-off score at the desired loss rate. Credit scoring is discussed in the Scoring and Modeling chapter.

CREDIT BUREAU PREFERENCES

Information in a consumer's credit file is not necessarily identical across all credit bureaus. Banks often maintain a table reflecting preferences for certain credit bureaus to be used in the underwriting (and account management) process. The table is usually based on the geographic locations targeted. Management's periodic analysis of bureau preference to determine optimal credit bureaus for different states or localities should be subject to examination review. Optimal credit bureaus are generally described as giving the most comprehensive, accurate, relevant, and timely information on the consumer such that the bank can make the most informed credit and pricing decisions possible based on available information.

POST-SCREENING

Post screening is a supplementary risk management tool. Sound pre-screening criteria is a first-line of defense against taking on undesirable accounts, and post-screening will not correct poor selection criteria. Nevertheless, it can effectively reduce the exposure from undesirable accounts. Post-screening is a process used in conjunction with pre-screened solicitations to identify potentially bad, versus good, accounts. New credit reports are obtained for respondents after the consumer accepts the pre-screened offer and are reviewed for negative information established after the pre-screened list was created or missed in the initial screening.

The FCRA significantly limits an institution's ability to deny credit once an offer has been accepted. Nevertheless, in some situations, management may be able to take action to reduce risk to the bank. A pre-screened credit offer may be withdrawn in certain situations. Bankruptcy, foreclosures, judgments, attachments, and similar items may be grounds for withdrawing an offer if such items occurred between the prescreen and the consumer's acceptance ONLY if these criteria were part of the original prescreening. Identifying and rejecting these potentially bad accounts reduces the bank's exposure to loss. In addition, an institution is not required to grant credit if the consumer is not creditworthy or cannot furnish required collateral, provided that the underwriting criteria are determined in advance and applied consistently. If the consumer no longer meets the lender's predetermined criteria, the lender is not required to issue the credit card. For example, if the cut-off score in the predetermined criteria is 700 and the consumer's credit score has deteriorated to 695 at the time of post-screen, the institution would most likely not be required to issue the credit card. However, if the consumer's score fell from 780 to 704, the institution would still have to grant credit because the consumer met the pre-determined standard. Depending on the specifics of the offer, the bank might be able to reduce the size of the line extended, provided that any relationship between the credit score and the amount of credit line given is also pre-determined by the institution before the offer was made.

FACT ACT

In addition to marketing considerations, certain FACT Act provisions are applicable to the underwriting and origination process. Section 112 of the FACT Act addresses fraud alerts and active duty status alerts. According to the provisions, prospective users of a consumer credit report that reflects fraud alerts or active duty alerts generally may not establish certain new credit plans or extensions of credit in the name of the consumer unless certain criteria are met, including specified verification or contact procedures. Credit cannot be denied based on the existence of a fraud alert or active duty alert. Rather, the bank must use the specified methods to verify the identity of consumers with such alerts on their records. In addition, FACT Act provisions provide that certain entities that make or arrange certain mortgage loans secured by 1-4 family properties for consumer purposes using credit scores must provide the score and a standardized disclosure to the applicants. Examiners should familiarize themselves with FACT Act provisions and consult with their compliance counterparts if they run across concerns.

MULTIPLE ACCOUNTS

Without proper controls, multiple account strategies can rapidly and significantly increase the bank's risk profile. The elevated risk profile may come in many forms, such as excessive credit risk or elevated reputation risk. Ill-managed multiple account strategies can exacerbate portfolio deterioration trends.

Management's practices for considering the bank's entire relationship with an applicant, including, but not limited to, any other existing card accounts, should be incorporated into the examination review. The bank's system to aggregate related credit exposures should also undergo review. In extreme cases, some banks have granted additional accounts to borrowers who were already experiencing payment problems on their existing accounts. Examiners should expect management to carefully consider and document its decision to offer multiple accounts, especially when the products offered are accompanied by substantial fees that limit credit availability and card utility. A best practice for management is to identify why use of a multiple account strategy was selected as compared to use of a line increase program. For banks that offer multiple credit lines, examiners should see evidence that management has established sufficient reporting to show items such as count, balance, and performance of cardholders that hold more than one account. They should also determine whether management compares the performance of multiple account portfolios against the performance of portfolios where each cardholder maintains only one account. Regulators can and have required banks to discontinue multiple account strategies when management has not provided for these necessary and appropriate management tools and reporting. If multiple account strategies are not offered, examiners should evaluate how management prevents multiple accounts from being issued.

INITIAL CREDIT LINE ASSIGNMENTS

With the profitability potential that credit cards typically exude, issuers usually try to assign the highest credit lines possible. But, the potential rewards must be balanced with the risks for the programs to be effective. Thus, it is critical that initial credit line assignments are based on sound credit information. Inadequate analysis of repayment capacity usually results in consumers receiving higher credit lines than they may be able to service and the risk of default heightening.

Criteria for line assignments varies but is often based on a combination of credit bureau score, income level, and/or other criteria. In any case, the credit lines assigned should be commensurate with the consumer's creditworthiness and ability to repay in accordance with soundly-established terms, including emphasis on a reasonable amortization period. As discussed in the Marketing and Acquisition chapter, some banks assign the credit line up front and disclose the line to the consumer as part of the pre-approved offer while other banks assign the credit line on the back end, such as by offering the consumer a credit limit up to a maximum amount in the solicitation. For back-end credit line assignment, the amount of the credit line is not assigned until the consumer responds to the solicitation.

As discussed in that chapter, compliance, credit, reputation, and other risks may arise depending on credit availability and card utility at account opening. Banks that offer products with limited credit availability or card utility at account opening are expected to maintain careful and thorough analysis demonstrating that the product will be and is marketed and underwritten in such a way to fully address the various accompanying safety and soundness and consumer protection concerns raised by such products.

POLICY AND UNDERWRITING EXCEPTIONS

Policy and underwriting **exceptions** are conditions in approved loans that contravene the bank's lending policies or underwriting guidelines. In an automated approval environment, policy exceptions should be rare. However, if the underwriting process includes a judgmental element, overrides are more likely to occur. Examiners should look for evidence that management has provided guidelines and limitations for granting loans that do not conform to the lending policy and underwriting guidelines and that it has established procedures for tracking and monitoring loans approved as exceptions.

Tracking exceptions is a valuable tool for several reasons. In addition to aiding the assessment of portfolio risk profiles and the adequacy of loss allowances, it helps hold staff accountable for policy compliance and reassess the appropriateness of existing policies and practices.

Exceptions are tracked both on an individual and aggregate basis. Tracking the aggregate level of exceptions is common and helps detect shifts in the risk characteristics of the credit card portfolio. It facilitates risk evaluation and helps management identify new business and training opportunities. Analysis of aggregate exceptions eventually enables management to correlate particular types of exceptions with a higher probability of default. Policy and underwriting exceptions that are viewed individually might not appear to substantially increase risk. But, when aggregated, those same exceptions can considerably increase portfolio risk. As such, early detection and analysis of adverse trends in exceptions is a necessary element for ensuring timely and appropriate corrective action.

An excessive or increasing volume or a pattern of exceptions could signal unintended or unwarranted relaxation in underwriting practices. If the volume of exceptions is high, management may be prompted to reconsider its risk tolerance, revise policies to be better aligned with the credit culture or current market conditions, establish new limits on the volume of exceptions, or change the type of exceptions permitted. When management has revised policies in response to high volumes of exceptions, examiners should assess the implications of the revisions, including impacts on the bank’s risk profile.

While high volumes of exceptions may indicate increased risk, so can a lack of exceptions. A lack of exceptions may indicate that the policy is too general to set clear limits on underwriting risk. If examiners identify an absence of exceptions, they should carefully review the bank’s policies to ascertain whether such policies provide adequate and clear guidance and limits.

Examiners should gauge the sufficiency of portfolio managers’ procedures for comparing the performance of exception loans with that of loans made within established guidelines. To facilitate comparison, management often uses exception coding and retains it even if the condition triggering the coding no longer exists. Examiners should review management’s practices for dropping exception codes or re-coding and should identify whether the practices skew or spoil the effectiveness of exception tracking.

INDICES AND REPORTING

A variety of indices are available regarding the underwriting function and its relationship with the marketing function. Items of interest include, but are not limited to:

- Origination cost per account, which is the total origination cost over a measurement period in relation to the number of accounts that were originated during that same period. It measures the cost of establishing a new account relationship.
- Approval rate, which is the number of accounts approved over a measurement period in relation to the number of applications (or responses) received.
- Booking rate, which is the number of accounts actually booked over a measurement period in relation to either the number of approved accounts or the number of applications (or responses) received. In some instances the customer applies for credit but then declines the offer after approved.
- Override rate, which is the number of overrides over a measurement period in relation to the number of applicants in the population.
- High-side override rate, which is the number of applicants over the cut-off score who were denied credit in relation to the number of applicants over the cut-off score.
- Low-side override rate, which is the number of applicants below the cut-off score who were given credit in relation to the number of applicants below the cut-off score.
- Application processing time, which is the amount of time it takes the institution to

process the application from the time of receipt to the point the credit decision is made and communicated to the consumer.

Portfolio problems can frequently be traced back to the bank's business generation and underwriting practices. Management is expected to devote sufficient resources to analyze changes in underwriting and credit scores, use appropriate systems and analytical tools to examine the results, and monitor warning signs of market deterioration. Common reports found in the underwriting department include, but are not limited to, those detailing policy changes, average credit score for new accounts, average initial credit lines assigned, approval rates, booking rates, and costs associated with the marketing and underwriting functions. Examiners should also determine whether management is monitoring reports as detailed in the Multiple Account Strategies and Policy and Underwriting Exceptions sections of this chapter. They should also look for evidence that management is using appropriate and sufficient segmentation techniques (program type, vintage, marketing channel, score distribution, etc.) within its reporting and is frequently monitoring marketing reports, usually no less than monthly.

SUMMARY OF EXAMINATION GOALS – UNDERWRITING AND LOAN APPROVAL PROCESS

Review of the underwriting and loan approval process is important because the goal of the examination is not only to identify current portfolio problems, but to identify potential problems that may arise from ineffective policies, unfavorable trends, lending concentrations, or non-adherence to policies. Examiners normally review items such as:

- The structure of the underwriting department and the expertise of its staff.
- Applicable board and/or committee minutes (in coordination with the examiner-in-charge).
- Underwriting policies and procedures.
- Underwriting chronology logs or similar documents summarizing changes in the underwriting and loan approval process.
- Planned underwriting and loan approval changes.
- Management reporting, tracking, and monitoring, including department statistics, portfolio statistics, and other segmentation statistics.
- Automated underwriting systems.
- Controls over judgmental underwriting processes.
- Management's identification of and response to adverse trends in the underwriting and loan approval area.
- Audits or other reviews of the underwriting and loan approval function.

The following items might signal current or future elevated risk and, thus, might warrant follow-up:

- Excessive or rapidly rising approval rates.
- Frequent or substantial changes in underwriting criteria.
- High employee turnover in the department.
- High or increasing exception volumes.
- Extremely low or non-existent exception volumes.
- High or increasing volume of accounts closed shortly after booking.
- Adverse performance of multiple account holders compared to cardholders with only one account.
- Few or ineffective management reports.
- Trends in the credit score distribution toward higher-risk accounts.
- High or increasing volume of consumer complaints.
- Credit lines inconsistent with products offered or with the target market's risk profile.
- Trends showing marked changes in average assigned lines.

These lists are not exhaustive, and examiners must exercise discretion in determining the expanse and depth of examination procedures to apply. If examiners identify significant concerns, they should expand procedures accordingly.

VIII. SCORING AND MODELING

Scoring and modeling, whether internally or externally developed, are used extensively in credit card lending. Scoring models summarize available, relevant information about consumers and reduce the information into a set of ordered categories (scores) that foretell an outcome. A consumer's score is a numerical snapshot of his or her estimated risk profile at that point in time. Scoring models can offer a fast, cost-efficient, and objective way to make sound lending decisions based on bank and/or industry experience. But, as with any modeling approach, scores are simplifications of complex real-world phenomena and, at best, only approximate risk.

Scoring models are used for many purposes, including, but not limited to:

- Controlling risk selection.
- Translating the risk of default into appropriate pricing.
- Managing credit losses.
- Evaluating new loan programs.
- Reducing loan approval processing time.
- Ensuring that existing credit criteria are sound and consistently applied.
- Increasing profitability.
- Improving targeting for treatments, such as account management treatments.
- Assessing the underlying risk of loans which may encourage the credit card backed securities market by equipping investors with objective measurements for analyzing the credit card loan pools.
- Refining solicitation targeting to minimize acquisition costs.

Credit scoring models (also termed scorecards in the industry) are primarily used to inform management for decision making and to provide predictive information on the potential for delinquency or default that may be used in the loan approval process and risk pricing. Further, credit risk models often use segment definitions created around credit scores because scores provide information that can be vital in deploying the most effective risk management strategies and in determining credit card loss allowances. Erroneous, misused, misunderstood, or poorly developed and managed scoring models may lead to lost revenues through poor customer selection (credit risk) or collections management. Therefore, an examiner's assessment of credit risk and credit risk management usually requires a thorough evaluation of the use and reliability of the models. The management component rating may also be influenced if governance procedures, especially over critical models, are weak. Regulatory reviews usually focus on the core components of the bank's governance practices by evaluating model oversight, examining model controls, and reviewing model validation. They also consider findings of the bank's audit program relative to these areas. For purposes of this chapter, the main focus will be scoring and scoring models. A brief discussion on validating automated valuation models (AVM) is included in the Validation section of this chapter, and loss models are discussed in the Allowances for Loan Losses chapter. Valuation modeling for **residual interests** is addressed in the Risk Management Credit Card Securitization Manual.

Scoring models are developed by analyzing statistics and picking out cardholders' **characteristics** thought to be associated with creditworthiness. There are many different ways to compress the data into scores, and there are several different outcomes that can be modeled. As such, scoring models have a wide range of sophistication, from very simple models with only a few data inputs that predict a single outcome to very complex models that have several data inputs and that predict several outcomes. Each bank may use one or more generic, semi-custom, or custom models, any of which may be developed by a scoring company or by internal staff. They may also use different scoring models for different types of credit. Each bank weighs scores differently in lending processes, selects when and where to inject the scores into the processes, and sets cut-off scores consistent with the bank's risk appetite. Use of scoring models provides for streamlining but does not permit banks to improperly reduce documentation required for loans or to skip basic lending tenants such as collateral appraisals or valuations.

Practices regarding scoring and modeling not only pose consumer lending compliance risks but also pose safety and soundness risks. A prominent risk is the potential for model output (in this case scores) to incorrectly inform management in the decision-making process. If problematic scoring or score modeling cause management to make inappropriate lending decisions, the bank could fall prey to increased credit risk, weakened profitability, liquidity strains, and so forth. For example, a model could wrongly suggest that applicants with a score of XYZ meet the bank's risk criteria and the bank would then make loans to such applicants. If the model is wrong and scores of XYZ are of much higher risk than estimated, the bank could be left holding a sizable portfolio of accounts that carry much higher credit risk than anticipated. If delinquencies and losses are higher than modeling suggests, the bank's earnings, liquidity, and capital protection could be adversely impacted. Or, if such accounts are part of a securitization, performance of the securitization could be at risk and could put the bank's liquidity position at risk, for instance, if cash must be trapped or if the securitization goes into **early amortization**. A poorly performing securitization would also impact the fair value of the residual interests retained.

Well-run operations that use scoring models have clearly-defined strategies for use of the models. Since scoring models can have significant impacts on all ranges of a credit card account's life, from marketing to closure, charge-off, and recovery, scoring models are to be developed, implemented, tested, and maintained with extreme care. Examiners should expect management to carefully evaluate new models internally developed as well as models newly purchased from vendors. They should also determine whether management validates models periodically, including comparing actual performance to expected performance. Examiners should expect management to:

- Understand the credit scoring models thoroughly.
- Ensure each model is only used for its intended purpose, or if adapted to other purposes, appropriately test and validate it for those purposes.
- Validate each model's performance regularly.
- Review tracking reports, including the performance of overrides.
- Take appropriate action when a model's performance deteriorates.
- Ensure each model's compliance with consumer lending laws as well as other regulations and guidance.

Most likely, scoring and modeling will increasingly guide risk management, capital allocation, credit risk, and profitability analysis. The increasing impetus on scoring and modeling to be embedded in management's lending decisions and risk management processes accentuates the importance of understanding scoring model concepts and underlying risks.

TYPES OF SCORING

Some banks use more than one type of score. This section explores scores commonly used. While most scores and models are generally established as distinct devices, a movement to integrate models and scores across an account's life cycle has become evident.

FICO Scores

Credit bureaus offer several different types of scores. Credit bureau scores are typically used for purposes which include:

- Screening pre-approved solicitations.
- Determining whether to acquire entire portfolios or segments thereof.

- Establishing cross-sales of other products.
- Making credit approval decisions.
- Assigning credit limits and risk-based pricing.
- Guiding account management functions such as line increases, authorizations, renewals, and collections.

The most commonly known and used credit bureau scores are called FICO scores. FICO scores stem from modeling pioneered by Fair, Isaac and Company (now known as Fair Isaac Corporation) (Fair Isaac), hence the label "FICO" score. Fair Isaac devised mathematical modeling to predict the credit risk of consumers based on information in the consumer's credit report. There are three main credit bureaus in the United States that house consumers' credit data: Equifax, TransUnion, and Experian. The credit-reporting system is voluntary, and lenders usually update consumers' credit reports monthly with data such as, but not limited to, types of credit used, outstanding balances, and payment histories. A consumer's bureau score can be significantly impacted by a bank's reporting practices. For instance, some banks have not reported certain information to the bureaus. If credit limits are not reported, the score model might use the high balance (the reported highest balance ever drawn on the account) in place of the absent credit limit, potentially inflating the utilization ratio and lowering the credit score. Errors in, or incompleteness of, consumer-provided or pubic record information in credit reports can also impact scoring. Consumer-supplied information comes mainly from credit applications, and items of public record include items such as bankruptcies, court judgments, and liens.

Each bureau generates its own scores by running the consumer's file through the modeling process. Although banks might not use all three bureaus equally, the scoring models are designed to be consistent across the bureaus (even though developed separately). Thus, an applicant should receive the same or a similar score from each bureau. In reality, variations (usually minor) arise due to differences in the way the bureaus collect credit information (for example, differences in the date of data collection) or due to discrepancies among information the bureaus, which could include inaccurate information. FICO scores rank-order consumers by the likelihood that they will become seriously delinquent in the 24 months following scoring. FICO scores of 660 or below may be considered illustrative of subprime lending (as set forth in the January 2001 *Expanded Guidance for Subprime Lending*), although other characteristics are normally considered in subprime lending determinations as well.

Benefits of credit bureau scoring include that it is readily available, is relatively easy to implement, can be less expensive compared to internal models, and is usually accompanied by various bureau-provided resources. Disadvantages include that scoring details are, for the most part, confidential and that it is available to every lender (no competitive differentiation).

As is the case for any type of scores generated by models, FICO scores are inherently imperfect. Nevertheless, they usually maintain effective rank ordering and can be useful tools, particularly when resource or volume limitations preclude the development of a custom score. Several types of FICO scores are in use including Classic FICO, NextGen FICO Risk, FICO Expansion, and FICO Industry Options. Collectively, the scores are called FICO scores in this manual.

There are three different Classic FICO scores, one at each of the bureaus. According to www.fairisaac.com, they are branded as Beacon scores at Equifax; FICO Risk or Classic (formerly known as EMPIRICA) scores at TransUnion; and Experian/Fair Isaac Risk Model scores at Experian. Scores range from 300 to 850, with higher scores reflecting lower credit risk.

NextGen FICO Risk scores draw their name from being touted as the "next generation" of credit bureau scores. They are branded as Pinnacle at Equifax; FICO Risk Score, NextGen (formerly PRECISION) at TransUnion; and Experian/Fair Isaac Advanced Risk Score at Experian. Compared to Classic scores, NextGen scores are reported to use more complex predictive variables, an expanded segmentation scheme, and a better differentiation between degrees of future payment performance. According to www.fairisaac.com, the score range, 150 to 950, is widened, although odds-to-score ratios at interval score ranges remain the same. Cumulative odds may vary.

For accounts lacking sufficient credit file information to generate a Classic or NextGen FICO score, some lenders use the FICO Expansion score. The FICO Expansion score, introduced in 2004, likely draws its name from "expanding" the credit information considered in the score to beyond that collected in a standard credit report. The expanded information includes items such as payday loans, checking account usage, and utility and rental payments. The FICO Expansion score has the same range and scaling as the Classic scores.

FICO Industry Options scores draw their name from being specific to several options of industries, such as bankcard.

VantageScore

The bureaus historically used their own proprietary models (based on Fair Isaac modeling) to develop FICO scores. However, in 2006, the bureaus introduced a new scoring system under which a single methodology is used to create scores at all three bureaus. The new system is called VantageScore. Because a single methodology is used, the score for each consumer should virtually be the same across all three bureaus. Any differences are attributed to differences in data in the consumer's files. The score will continue to incorporate typical consumer report file content but will range from 501 to 990. The scores are scaled similar to the letter grades of an academic scale (A, B, C, D, and F). Again, the higher the score, the lower the credit risk. Consumers may likely have VantageScores that are higher than their FICO scores. This is due to scaling and that phenomena alone does not indicate that a consumer is a better credit risk than he or she was under the traditional FICO score system. Further, when determining whether subprime lending exists, the new scale will need to be considered (in other words, 660 may not be a benchmark when looking at VantageScores). The industry's rate of replacement of custom and generic scores with VantageScore remains to be seen as of the writing of this manual.

Other Scores

In addition to or instead of generic credit bureau scores, many banks use other types of scores. Brief discussions on a variety of these scores follow, in alphabetical order. The bureaus and other vendors offer models for many of these types of scoring.

Application Scoring:

Application scoring involves assigning point values to predictive variables on an application before making credit approval decisions. Typical application data include items like length of employment, length of time at current residence, rent or own residence, and income level. Points for the variables are summed to arrive at an application score. Application scores can help determine the credit's terms and conditions.

Attrition Scoring:

Attrition scores attempt to identify consumers that are most likely to close their accounts, allow their accounts to go dormant, or sharply reduce their outstanding balance. Identification of such accounts may allow management to take proactive measures to cost-effectively retain the accounts and build balances on the accounts.

Bankruptcy Scoring:

Bankruptcy scores attempt to identify borrowers most likely to declare bankruptcy. HORIZON (by Fair Isaac) is a common credit bureau bankruptcy score.

Behavior Scoring:

Behavior scoring involves assigning point values to internally-derived information such as payment behavior, usage pattern, and delinquency history. Behavior scores are intended to embody the cardholder's history with the bank. Their use assists management with evaluating credit risk and correspondingly making account management decisions for the existing accounts. As with credit bureau scores, there are a number of scorecards from which behavior scores are calculated. These scorecards are designed to capture unique characteristics of products such as private label, affinity, and co-branded cards.

Behavior scoring systems are often periodically supplemented with credit bureau scores to predict which accounts will become delinquent. Using a combination allows management to evaluate the composite level of risk and thus vary account management strategies accordingly.

Adaptive control systems (ACS) commonly use behavior scoring. ACS bring consumer behavior and other attributes into play for decisions in key management disciplines (for instance, line management, collections, and authorizations) so as to reduce credit losses and increase promotional opportunities. ACS include software packages that assist management in developing and analyzing various strategies taking into account the population and economic environment. They are a combination of software actionable analytics and optimization techniques and use risk/reward logic. ACS recognize that accounts can go in several directions. They consider the possible outcomes of the options and determine the "best" move to make. With ACS, challenger strategies can be tested on a portion of the accounts while retaining the existing strategy (champion strategy) on the remainder. Continual testing of alternative strategies can help the bank achieve better profits and control losses. Many large banks use TRIAD (developed by Fair Isaac) or a similar ACS, but smaller banks may lack the capital or the infrastructure to implement such a process.

Collection Scoring:

Collection scoring systems rank accounts by the likelihood of taking delivery of payments due. They are used to determine collection strategies, collection queue assignments, dialer queue assignments, collection agency placement, and so forth. Collection scores are normally used in the middle to late stages of delinquency.

Fraud Detection Scoring:

Fraud detection scores attempt to identify accounts with potential fraudulent activity. Fraud continues to be pervasive in the credit card lending industry and detection of potential fraudulent activity can help identify and control losses as well as assist management in developing fraud prevention controls.

Payment Projection Scoring:

Payment projection scoring models use internal data to rank accounts, normally by the relative percentage of the balance that is likely to be repaid. Some models only forecast the relative percentage, while others rank the likelihood a cardholder will pay a moderate to high level of the account balance. The scores are normally used in the early to middle stages of delinquency.

Recovery Scoring:

Recovery scoring models rank order the amount of recovery that is expected after charge-off. They aid management in deploying the necessary resources where collection is most likely and help with agency placement and sale decisions.

Response Scoring:

Response scoring models are used to manage acquisition costs. By identifying the consumers that are most likely to respond, a bank is able to tailor its marketing campaigns so as to target its marketing toward those consumers that are most likely to respond and to steer away from spending marketing dollars on consumers that are least likely to respond.

Revenue Scoring:

Revenue scoring models rank order the potential revenue expected to be generated on new accounts during the first 12-month period. The models use predictive indicators such as usage ratios, the level of revolving balances, and other card-usage patterns. Revenue scoring allows management to focus marketing initiatives on what are expected to be the most profitable accounts. Used in conjunction with credit bureau scores in screening applicants, they allow management to evaluate the revenue potential as well as the risk ranking of prospects. Consequently, management is better able to identify its target market and tailor its solicitations to that market.

Revenue scoring is also used to manage existing accounts according to revenue potential. Strategies can be formulated recognizing the risk, revenue, and frequency of cardholder use. From this information, management is better able to reward low-risk, product-loyal consumers by reducing APRs or waiving fees. Conversely, management is apt to raise APRs and fees for consumers who exhibit higher risk or that evidence little product loyalty.

DUAL-SCORING MATRIX

A dual-scoring matrix is a system which uses one score on one axis and another score on its other axis. Examiners should normally expect to see dual scoring in more complex credit card operations. Any scoring system may interface with another, but a commonly employed dual-scoring matrix uses application and credit bureau scores. The use of two scores allows management to more effectively segment applicants. Each score has a cut-off level (as discussed later in this chapter). Applicants that either pass or fail both cut-off scores are either accepted or rejected, respectively. A gray area arises when an applicant passes one cut-off but fails the other. These situations afford management a greater opportunity to maximize approvals or minimize losses by including potentially good credit risk or by excluding potentially bad credit risk that may have gone undetected in a single-scoring system. Taking advantage of this opportunity requires a thorough tracking system so that management can determine the historical loss rates for the score combinations in the gray area. Cut-off scores can then be adjusted so that the best scoring combinations are approved and so that applicants who would be approved under a single-score system, yet still pose unacceptable risks, can be identified and excluded.

CREDIT SCORING MODEL DEVELOPMENT

Scoring can be done with generic models, semi-custom models, or custom models. When properly designed, models are usually more reliable than subjective or judgmental methods. However, development and implementation of scoring models and review of these models present inherent challenges. These models will never be perfectly right and are only good if users understand them completely. Further, errors in model construction can lead to inaccurate scoring and consequently to booking riskier accounts than intended and/or to a failure to properly identify and address heightened credit risk within the loan portfolio. Errors in construction can range from basic formula errors to sample-bias to use of inappropriate predictive variables.

A scoring model evaluates an applicant's creditworthiness by bundling key attributes of the applicant and aspects of the transaction into a score and determines, alone or in conjunction with an evaluation of additional information, whether an applicant is deemed creditworthy. In brief, to develop a model, the modeler selects a sample of consumer accounts (either internally or externally) and analyzes it statistically to identify predictive variables (independent variables) that relate to creditworthiness. The model outcome (dependent variable) is the presumed effect of, or response to, a change in the independent variables.

The sample selected to build the model is one of the most important aspects of the developmental effort. A large enough sample is needed to make the model statistically valid. The sample must also be characteristic of the population to which the scorecard will be applied. For example, as stated in the March 1, 1999 *Interagency Guidance on Subprime Lending* (Subprime Lending Guidance), if the bank elects to use credit scoring (including application scoring) for approvals or pricing in a subprime lending program, the scoring model should be based on a development population that captures the behavioral and other characteristics of the subprime population targeted. Because of the significant variance in characteristics between subprime and prime populations, banks offering subprime products should not rely on models developed solely for products offered to prime borrowers.

Both a large number of good and bad accounts are necessary to maximize the model's effectiveness. There are no hard and fast rules, but the sample selected normally includes at least 1,000 good, 1,000 bad, and about 750 rejected applicants. Often, the sample contains a much higher volume of accounts. The definition of good and bad accounts (the dependent variable) differs among banks, especially between prime and subprime issuers. Furthermore, definitions of bad for scoring purposes are not necessary the same as definitions of bad used by banks for charge-off or nonaccrual consideration. For prime portfolios, good accounts tend to be defined as accounts with sufficient credit history and little or no delinquency. Bad accounts for prime portfolios are normally distinguished by adverse public records, delinquency of 90 days or more, accounts with a history of delinquency, and accounts charged-off. Rejected applicants are applicants that management refused to accept because of their risk parameters. Certain inferences are made to break down the rejected applicants into good and bad accounts. This procedure, known as **reject inferencing**, makes certain assumptions on how rejected applicants would have performed had they been accepted and attempts to mitigate any accept-only bias of the sample. The process is used as it would be cost-prohibitive and potentially detrimental to make loans to consumers who would otherwise be rejected just for the sake of improving models.

After a representative sample has been assembled, the accounts are analyzed to determine the characteristics and attributes common to each group. The characteristics may be based on data sources such as the consumer's credit report, the consumer's application, and the bank's records. Characteristics are the questions asked on the application or performance categories of the credit bureau report. Attributes are the answers given to questions on the application or entries on the credit bureau report. For example, if education is a characteristic, college degree or high school diploma illustrate possible attributes.

The characteristics, which may number in the hundreds, are refined into a much smaller group of predictive variables, which are those items thought to best indicate whether a new applicant will eventually fall into the good or bad performance category. Ideally, the predictive variables also maintain a stable relationship with the performance measurement over-time. Commonly used predictive variables include, but are not limited to, prior credit performance, current level of indebtedness, amount of time credit has been in use, pursuit of new credit, time at present address, time with current employer, type of residence, and occupation. Examiners should expect that management has excluded factors lacking predictive value or that by law cannot be used in the credit decision-making process (such as race).

Once the predictive variables have been selected, points are assigned to the attributes of those variables. Each attribute is awarded points, and determining the number of points to award each attribute may be the most difficult element of the process. There are several methods for calculating and assigning points, all using a form of multivariate statistics. A scoring table is constructed, for which characteristics are on one axis and attributes are on the other axis. Points are awarded to each cell of the matrix. The consumer's characteristics and attributes are compared with the scoring table, or scorecard, and are awarded points according to where they fall within the table. The points are tallied to arrive at the overall score. Whether a high score means low or high risk depends on the model's construction.

Once designed and prior to implementation, the model is evaluated for integrity, reliability, and accuracy by a party independent of its design. This process is referred to as validation. A sample from the development sample may be held-out and scored with the new model. Performance is then monitored, and a model that demonstrates separation and rank ordering on the hold-out sample is considered valid. Validations for independent samples are also usually conducted prior to release of the model and post-implementation.

Validation has long been fundamental to a successful score modeling process, and evaluating a bank's model validation process has long been a central component of the examination. The Subprime Lending Guidance requires management to review and update models for subprime lending to ensure that assumptions remain valid. Validation is also an integral part of the proposed rulemaking for the revised Basel capital accord.

BASEL CONSIDERATIONS REGARDING CREDIT SCORING

A brief discussion on the new Basel capital accord is housed in the Capital chapter. Under the proposed rulemaking, banks that use an Internal Ratings Based (IRB) approach would use internal estimates of certain risk parameters as key inputs when determining their capital requirements. The IRB approach requires banks to assign each retail exposure to a segment or pool with homogeneous risk characteristics. These characteristics are often referred to as primary risk drivers and may include credit scores.

A bank must be able to demonstrate a strong relationship between the IRB risk drivers (such as scores) and comparable measures used for credit risk management. Thus, even if a bank uses custom scores for underwriting or account management, generic bureau scores could possibly be used for IRB segmentation purposes if the bank can demonstrate a strong correlation between these measures. A bank using credit scores as segmentation criterion would have to validate the choice of the score (bureau, custom, and so forth) as well as demonstrate that the scoring system has adequate controls.

Examiners will expect that all aspects of the risk segmentation system, including credit scoring, are subject to thorough, independent, and well-documented validation. Validation for the risk segmentation system is ultimately tied to validation of the bank's quantification of IRB risk parameters. Examiners will also expect that the IRB validation process include:

- Evaluating the developmental evidence or logic of the system.
- Ongoing monitoring of system implementation and reasonableness (verification and benchmarking).
- Comparing realized outcomes with predictions (back-testing).

VALIDATION

Examiners should determine whether management provides for appropriate, ongoing validation of scoring models, whether used as part of an IRB framework, for credit risk management, or for other purposes. Validation is a process that tests the scoring system's ability to rank order as designed and essentially answers whether the model is accurate and working properly. Model validation does not only increase confidence in the reliability of a model but also promotes improvements and a clearer understanding of a model's strengths and weaknesses among management and user groups. Model validation can be costly, particularly for smaller banks. But, using un-validated models to manage risks is a poor business practice that can be even more costly as well as lead to safety and soundness concerns. Risks from not validating are elevated when a bank bases its credit card lending decisions on the scoring model alone (and does not consider other factors in the decision-making process), when the model is otherwise vital, or when the model is complex.

Examiners do not validate models; rather, validation is the responsibility of bank management. Examiners do, however, test the effectiveness of the bank's validation function by selectively reviewing aspects of the bank's validation work. Examiners could also identify concerns with a model's performance as a by-product of the credit risk review or other examination procedures.

Examiners should evaluate the bank's validation framework, including written validation policies, to determine if it is proper. Key elements of a sound validation policy generally include:

- Competent and Independent Review - The review should be as independent as practicable. The reviewer can be an auditor with technical skills, a consultant, or an internal party. In practice, model validation requires not only technical expertise but also considerable subjective business judgment.
- Defined Responsibilities - The responsibility for model validation should be formalized and defined just as the responsibility for model construction should be formalized and defined.
- Documentation - Validation cannot be properly performed if a sufficient paper trail of the model's design is not available. Weak documentation can be particularly damaging to the bank if the modeler leaves and the replacement is left with little to reference. Model documentation should summarize the general procedures used and the reasons for choosing those procedures, describe model applications and limitations, identify key personnel and milestone dates in the model's construction, and describe validation procedures and results. Technical complexity does not excuse modelers from the responsibility of providing clear and informative descriptions of the model to management.
- Ongoing validation - Validation should occur both pre- and post-implementation. Models should be subject to controls so that coding cannot be altered, except by approved parties. Most models are normally altered in response to changes in the environment or to incorporate improvements in understanding of the subject. Model alterations that are inappropriate can result in dodging risk limits or disguising losses.
- Auditor involvement - Examiners should expect that the bank's audit program ensures that validation policies and procedures are being followed.

A clear understanding of the scoring model's intended use is critical to properly assessing a model's performance. But, regardless of the intended use, the three key components of a validation process, as mentioned in the prior section, apply: evaluation of the conceptual soundness of the model; ongoing monitoring that includes verification and benchmarking; and outcomes analysis.

Evaluating conceptual soundness involves assessing the quality of the model's construction and design. Examiners should determine whether management reviews documentation and empirical evidence supporting the methods used and the variables selected in the model's design. Modelers adopt methods, decide on characteristics, and make adjustments. Each of these actions requires judgment, and validation should ensure that judgments are well-informed. Examiners should expect management to review developmental evidence for new models and when a material change is made to an existing model.

The purpose of the second component of validation, ongoing monitoring, is to confirm that the model was implemented appropriately and continues to perform as intended. Process verification and benchmarking are its key elements. Process verification includes making sure that data are accurate and complete; that models are being used, monitored, and updated as designed; and that appropriate action is taken if deficiencies exist. Benchmarking uses alternative data sources or risk assessment approaches to draw inferences about the correctness of model outputs before outcomes are actually known. The time needed to generate a sufficient number of representative accounts (good and bad) to evaluate the effectiveness of the model post-implementation will vary depending on the product-type or customer group. Consequently, benchmarking becomes an important tool in the validation process because it provides an earlier-read of model performance than is available from back-testing.

The third component of validation, outcomes analysis, compares the bank's forecasts of model outputs with actual outcomes. It should include back-testing, which is the comparison of the outcomes forecasted by the models with actual outcomes during a sample period not used in model development (out-of-sample testing).

Benchmarking and back-testing differ in that when differences are observed between the model output estimates and the benchmark, it does not necessarily indicate that the model is in error. Rather, the benchmark is an alternative prediction, and the difference may be due to different data or methods. When reviewing the bank's benchmarking exercises, examiners should find out whether management investigates the source of the differences and determines whether the extent of the differences is appropriate.

Examiners can compare the delinquency rate at each score interval as a simple test of overall performance of the scoring system. If the system is performing adequately, a correlation between the scores and delinquency rates (that is, delinquency rates increase as projected risk (as reflected in the scores) increases) should be evident. Examiners may also want to review the results of various tests that management may be using. For example, divergence statistics and the population stability index are sometimes used. Divergence statistics measure the distance between the average score of satisfactory accounts and average score of unsatisfactory accounts. The greater the distance, the more effective the scoring system is at segregating good and bad accounts. If the difference is small, a new or redeveloped scoring system may be warranted. The population stability index compares divergence with the original development sample and helps identify and measure erosion in the model's predictive power. Other advanced statistical tools include Chi square, Kolomogorov-Smirnov (K-S) tests, and Gini coefficients. While examiners generally do not need to know the specifics of all of these types of tests, they should be aware that these tests are common in the industry and should expect management to be able to explain the validation tools used. Management's development of effective processes and exercise of sound judgment are just as important as the measurement technique used.

Incorporation of combinations of model expertise and skill levels in the validation process is not uncommon. For example, internal staff could be used to verify the integrity of data inputs while a third party could be used to validate model theory and code. Examiners should determine what management's procedures are for ensuring that vendors' validation procedures are appropriate and meet the bank's standards. Management is ultimately responsible for ensuring the validation processes used, whether internal or external, are appropriate and adequate.

While scoring models developed in-house are becoming more prevalent, banks continue to purchase a number of models from vendors and the bureaus. Vendors are sometimes unwilling to share key formulas, assumptions, and/or program coding. In these cases, the vendor typically supplies the bank with validation reports performed by independent parties. The independent party's work can only be relied on if the information provided is sufficient to determine the adequacy of the scope, the proper conveyance of findings to the vendor, and the adequacy of the vendor's response thereto. Examiners assessing risks of modeling activities should pay particular attention to situations in which management has exclusively relied on a vendor's general acceptance by others in the industry as sufficient evidence of reliability and has not conducted its own comprehensive review of the vendor and its practices.

Examiners should evaluate management's processes for re-tooling or re-developing models that exhibit eroding performance. If evidence reliably shows that the behavior shift is small and likely to be of short duration, a policy shift or change to the model may not be warranted. But, if evidence suggests that the behavior shift is material and is likely to be long-term, there are several approaches management may consider to limit losses, depending on the ability to identify the most likely reason(s) for the performance shift. It can adjust its underwriting policy to narrow the market to a group believed to perform better than the population in general. This usually involves making changes to the bank's business strategy and, thus, is rather limited as a short-term risk management tool. Banks may also develop or purchase scoring models based on more recent information about the current population. In this case, the bank must weigh the costs of developing or purchasing a model against that of carrying an increased number of bad accounts booked by the existing model. One of the most common, and often the easiest, adjustments is to manage the cut-off score to maintain a targeted loss rate consistent with profit objectives.

CUT-OFF SCORE

Each bank develops its own policies and risk tolerances for its credit card lending programs. Setting cut-off scores is one way banks implement those risk tolerances. A cut-off score is the point below which credit will not be extended and at or above which credit will be extended (assuming a higher score equates to better creditworthiness). A bank might have more than one cut-off score, with each tailored to a specific population. The ability to customize cut-off scores allows management to maximize the approval rate without sacrificing asset quality. Some banks have cut-off bands, which define a range of scores for which the consumer would undergo additional judgmental review.

Selecting a cut-off score involves determining the optimum balance between approval and loss rates. Management evaluates how much additional revenue will be added if the approval rate is increased and what the cost associated with the incremental increase in the bad rate will be. They also often give consideration to marketing expenses and customer service expenses. How management chooses to balance the competing goals determines the cut-off score. Odds charts are often involved in setting cut-off scores and are discussed in the next section.

As time passes, cut-off scores and models become less predictive because of economic changes, demographic shifts, and entry into new markets. Examiners should assess management's practices for reviewing cut-off scores and models, including resulting acceptance and loss rates. By monitoring the rates, management can appropriately adjust the cut-off score to change either acceptance rates or loss rates, depending on the strategic goals. For example, management could grow the portfolio by lowering the cut-off score (when lower scores equate to higher risk), taking on an elevated degree of credit risk and accepting increased loss rates. These dynamics of the scoring environment highlight the need for thorough tracking and **calibration** procedures.

VALIDATION CHARTS AND CALIBRATION

Most scores are rank-order measurements that, by themselves, are generally not indicative of the likelihood or magnitude of an event or outcome. Rather, they summarize a plethora of consumer data and essentially do little except rank order the consumer's risk against the risk of other consumers. But, in addition to this rank-ordering, scores must give accurate outcome (usually default) probabilities to be the most useful. Calibration is the process by which a model's output (in this case scores) is converted into the actual rate of the outcome (default) and includes adjusting or modifying for the difference between the expected rate based on the historical database and the actual rate observed. The process is aimed at converting or modifying the model's output into a probability based on the expected odds for the historical population and adjusting for the relevant population. Often, it is thought of as the process of determining and fine tuning the grades or gradation of a quantitative measuring system by comparing them with a set standard or starting point. Frequently the standard used might be a bureau's validation chart.

In general, validation charts (also commonly known as odds charts) reflect the estimate of the percentage of borrowers in a defined population who will evidence a certain trait or outcome, such as delinquency, loss, or bankruptcy. Examiners normally expect management to develop its own odds chart(s) when it has sufficient historical data. When properly developed, customized odds charts are more predictive than odds charts that are available from the bureaus. Validation charts available from the bureaus display the odds of poor performance (such as delinquency, loss, or bankruptcy) observed at a given bureau score. Each set of charts available from the bureaus is specific to a model, an industry, and an application (where application refers to how the scores will be used). For example, the bureaus have validation charts available for the bankcard industry and for subprime lending. The bureaus' validation charts can be helpful as a starting point for management in setting risk strategies but do not precisely predict the actual odds that each bank will experience. Rather, a bank's particular market will have different characteristics and, thus, different odds. The risk ranking based on bureau score will generally hold, but the actual odds of going bad that each score represents will vary between banks and portfolios. Thus, management must provide for sufficient calibration processes. For example, if the bureau odds chart indicates that 1 out of every 20 consumers with a credit score of XYZ will be a bad account and the bank is realizing 5 out of every 20 consumers with a credit score of XYZ is a bad account, calibration most likely is needed.

Calibration most often adjusts or refines an odds chart when significant variation exists from the general forecast. But, there are other instances for which the scores and scaling could be adjusted, or calibrated. For example, calibration might be used to make all scores positive. For example, if a model's scores are (52), (6), and 15, an entity could add 52 points, so the scores would be 0, 46, and 67. Also, calibration might be used to compress the scale (for example, if every 31 points doubles the odds of bad, a bank could calibrate the scale such that the bad odds are doubled every 20 points). Calibrations might also be done to make users feel comfortable (for example, if an existing cut off score is XYZ based on an internal model that predicts that one percent of accounts with a score of XYZ will be bad, then calibration could be used to ensure that accounts that are scored XYZ would continue to tie to the likelihood that one percent will be bad. In this way, the bank would not have to change the cut-off score to keep getting the same caliber of customers). Examiners should ascertain whether recent calibrations are well-documented and have been properly executed.

OVERRIDES

Overrides are discussed in the Underwriting and Loan Approval Process chapter. Exceptions outside of management's credit scoring parameters are called overrides and may be high-side or low-side. When management overrides the cut-off score, they introduce information into the ultimate credit decision that is not considered in the scoring system. If the scoring system is effectively predicting loss rates for a designated population and the system reflects management's risk parameters, examiners should expect that management use overrides with considerable caution. Excessive overrides may negate the benefit for an automated scoring system. A high volume of overrides is equivalent to having no cut-off score and jeopardizes management's ability to measure the success of the credit scoring system. Once a bank approves credits that fail to meet the scoring system's criteria, it has broken its odds and may be taking on higher levels of risk than acceptable for the bank's risk appetite and/or capabilities to control. However, business reasons may justify a temporary increase in override rates. For example, when transitioning to a new system, override rates might rise until a reasonable level of confidence in the new approach is achieved.

CREDIT SCORING MODEL LIMITATIONS

Determining whether scoring models are managed by people who understand the models' strengths and weaknesses is an integral part of the examination process. Users lacking a complete understanding of how the models are made, how they should be used, or how they interface with the bank's lending policies and procedures can expose the bank to risks, as discussed throughout this chapter. Scoring is only useful if its limitations are properly understood, and examiners should draw a conclusion about whether an understanding of the model's limitations by management is evident.

One limitation is that scoring model output is only as good as the input that is used. If data going into the scoring model is inaccurate (for instance, if information on the consumer's credit bureau report is erroneous), the model's output (score) will be erroneous. Depending on how the erroneous information is weighted in the scoring formula, the impact on the score could be substantial. Moreover, if management does not select and properly weight the best predictive variables, the model's output will likely be less effective than had the most predictive variables been used and properly weighted. Management must make sure that the variables used in the models are appropriate, predictive, and properly weighted to arrive at the best credit decision and that data inputs are complete and accurate.

The effectiveness of the model output (scores) can also be constrained by factors such as changing economic conditions and business environments. Examiners should identify whether management monitors warning signs of market deterioration, such as increases in personal bankruptcies, which may affect the accuracy of model assumptions. Robust models are typically more resilient to these types of changes.

Models, even if good at risk-ranking an overall market segment, can be limited if they do not reflect the bank's population. A model is typically developed for a certain target population and may be difficult to adapt to other populations. In most cases, a credit scoring model should only be used for the product, range of loan size, and market that it was developed for. When a bank tries to adapt the model to a different population, performance of that population may likely deviate from expectation. When a bank implements or adapts a model to a new market or population for which it was not designed, examiners should determine whether management performs an analysis similar in scope to the one used to validate the model at implementation.

Credit scoring is good at predicting the probability of default but generally not at predicting the magnitude of losses. (Normally, other models, such as loss models, focus on predicting the level (magnitude) of risk.) Generic credit scoring models in particular most likely rank order the risk appropriately but generally do not accurately predict the level of the risk. Thus, banks that use generic models should not assume that their loss rates will be the same as those reflected in industry odds charts. How accounts ultimately perform depends on a number of factors, including account management techniques used, the size of line granted, and so forth.

Scorecards could be considered, by their very nature, to be antiquated when they are put into production. They are based on lengthy historic data and take time to develop. Moreover, models are calibrated using historical data, so if relevant un-modeled conditions change, the model can have trouble forecasting out of sample.

Along similar lines, during times of strong economic growth, models may be ill-prepared to predict borrower performance in recessionary conditions, particularly if the historic period observed did not include recessionary conditions. There are several behaviors that could impact the model's effectiveness in recessionary times. One is that consumers might prioritize their payments to pay off secured debt rather than unsecured debt. In hard times, this could leave a bank that is holding the consumer's unsecured credit card debt as one of the last to get paid, if paid at all.

The effectiveness of scoring models can also be limited by human involvement. For example, when models are augmented by managerial judgment (for instance, in the case of overrides), results from the model and subsequent validation processes can become seriously compromised. In addition, unsupported overconfidence in the models could lead some banks to move up or down market to make larger or more risky loans, respectively. Without proper model validation, such movements could result in the bank taking on more credit risk than it can control.

AUTOMATED VALUATION MODELS

Automated valuation models (AVMs) are sometimes used to support evaluations or appraisals. Examiners should look at management's periodic validation of AVMs for mitigating the potential valuation uncertainty in the model and should confirm whether its documentation covers analyses, assumptions, and conclusions. Validation includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available) and should cover properties representative of the geographic area and property type for which the tool is used. Many vendors provide a "confidence score" which usually relates to the accuracy of the value provided. Confidence scores come in many formats and are calculated based on differing systems. Examiners should determine whether management understands how the models work as well as what the confidence scores mean and should confirm whether management has identified confidence levels appropriate for the risk in given transactions.

SUMMARY OF EXAMINATION GOALS – SCORING AND MODELING

The examiner's role is to evaluate scoring, model usage, and model governance practices relative to the bank's complexity and the overall importance of scoring and modeling to the bank's credit card lending activities. The role includes:

- Identifying the types of scoring systems used in the credit card lending programs and whether the models are generic, custom, or vendor-supplied. A model inventory is normally available for review.
- Determining how management uses scores in its decision-making processes and whether each model's use is consistent with the intended purpose.
- Assessing whether designated staff possess the necessary expertise.
- Determining whether management thoroughly understands the models used.
- Reviewing cut-off scores and odds charts to assess the level of risk being taken.
- Testing the effectiveness of the bank's validation function by selectively reviewing various aspects of the bank's validation work for key models.
    - Evaluating the scope of validation work performed.
    - Reviewing reports summarizing validation findings and any additional workpapers necessary to understand findings.
    - Evaluating management's response to the reports, including remediation plans and timeframes.
    - Assessing the qualifications of staff or vendors performing the validation.
- Assessing the bank's calibration procedures, including documentation thereof.
- Determining whether credit bureau, behavior, and/or other scores enhance account management and collection practices.
- Assessing override policies and practices.
    - Review the number/volume and types of overrides.
    - Verify that override reports are reviewed by management and that performance is adequately tracked.
    - Determine the impact, if any, of overrides on asset quality.
- Assessing whether the bank's audit program appropriately considers models and oversight thereof.
- Identifying instances in which management has taken action when performance of the scoring model deteriorated and determine if the action was appropriate, effective,

and timely.

- Determining if management is prepared to take future action if the scoring model's performance deteriorates.
- Determining if there are any models under development.
    - o Identify potential impacts on the bank from implementation of the forthcoming models.
    - o Understand what prompted the model development.
    - o Ascertain the planned implementation date of the model.
- For models developed by third parties, assessing whether the systems are supervised and maintained in accordance with vendor-provided specifications and recommendations.

Examiners normally select models for review in connection with the examination when model use is vital or increasing. Focus may also be placed on models new or acquired since the prior examination. Quantitative or information technology (IT) specialists are sometimes needed for some complex models, but examiners normally can perform most model reviews.

IX. PORTFOLIO MANAGEMENT

Portfolio management covers the full spectrum of overseeing and administering the credit card programs, portfolios, and accounts. It encompasses risk management, account management, portfolio reporting and monitoring, and many other activities. Inappropriate portfolio management practices can create sizable risk for the bank, including credit risk, reputation risk, liquidity risk, and other risks. Portfolio management is challenging because the goal is to offer the customer efficient services and responses while internally controlling costs, appropriately managing risks and revenues, and achieving corporate and regulatory compliance.

RISK MANAGEMENT

Risk management is considered the broadest of the portfolio management terms and involves the overall monitoring and managing of the quality and risks of the credit card portfolio. It includes, but is not limited to, evaluating underwriting standards and modifying those standards as needed to maintain an acceptable risk level in the portfolio. Account management, portfolio reporting and monitoring, consumer complaints, fraud, and other functions are also essential subsets of risk management. In all, risk management should address research, development, testing, and product roll out, to monitoring on-going performance of the products, to post-mortem analysis.

Aspects of the risk management function, such as the level of technology as well as the degree of sophistication and number of staff needed, normally depend on the size and complexity of the credit card activities and of the bank itself. Independence from those who make day-to-day marketing, underwriting, and account management decisions provides an important control. Risk management is sometimes performed by a separate risk management department. In other cases, the board might assign it to other functional areas such as loan review and/or credit administration. Regardless of where responsibility is assigned, examiners should look for evidence that management has implemented sound practices that identify risk, establish controls, and provide monitoring. In general, risk management is involved in many functions, including:

- Developing and implementing marketing initiatives to ensure that such initiatives do not create an unacceptable risk level in the portfolio.
- Confirming proper underwriting and marketing decisions.
- Assessing the integrity of scoring systems.
- Reviewing policies and procedures, including proposed revisions thereto, for adequacy, and assessing the impact of those policies and procedures on the card portfolio.
- Determining the quality of the credit card portfolio.
- Analyzing the success of specific products and marketing initiatives by assessing delinquencies and losses for each product or roll-out.
- Developing new, and assessing existing, account management strategies.
- Monitoring performance of the collections, fraud, and recovery functions, including recommending changes regarding management, staffing, or practices.

Common tools used for risk management include data warehouses, portfolio management software, credit scoring, ACS, and risk models. Data warehousing capabilities allow the storage and retrieval of pertinent data. ACS are discussed in the Scoring and Modeling chapter, but to reiterate, are decision-tree strategies used to formulate account management approaches. They bring consumer behavior and other attributes into play.

Risk management's purposes with regard to marketing and underwriting is to determine the characteristics of the responders and analyze the results of marketing programs to ascertain if they were successful in attracting the targeted populations. As a result of this process, management can adjust underwriting standards to maintain an acceptable risk level in the card portfolio. Marketing and underwriting are discussed in the Marketing and Acquisition chapter as well as the Underwriting and Loan Approval Process chapter. The remainder of this chapter largely focuses on risk management's role in the on-going servicing and monitoring of the card programs, portfolios, and accounts subsequent to marketing and underwriting. As such, account management and portfolio reporting and tracking are two key subjects of this chapter. Other risk management functions, such as loss allowances, are discussed in later chapters.

ACCOUNT MANAGEMENT GUIDANCE

Examinations have disclosed a wide array of risk management, account management, and loss allowance practices, many of which have been inappropriate and have substantially elevated banks' risk profiles. In response, the FDIC jointly issued the *Account Management and Loss Allowance Guidance for Credit Card Lending* (Account Management Guidance, or AMG) on January 8, 2003. The AMG is generally applicable to all FDIC-supervised institutions that offer credit card programs as well as to similar institutions supervised by other regulatory agencies. It generally applies regardless of where the receivables reside.

The AMG specifically speaks to credit line management, over-limit practices, minimum payments and **negative amortization**, workout and forbearance practices, and income and loss allowance practices. Regulatory scrutiny and risk management expectations for certain practices will be greater for higher-risk portfolios and portfolio segments, including those that are subprime. Less than full compliance with the AMG should generally be criticized. However, the Agencies do recognize that limited exceptions to the AMG may be warranted in well-managed programs. In those cases, examiners should expect that exceptions are addressed in the bank's policies and procedures, the volume of accounts granted exceptions is small and well-controlled, and management is closely monitoring the performance of those accounts.

An assessment of the overall adequacy of account management practices factors in the bank's risk profile, strength of internal controls, quality of management reporting, and adequacy of charge-off and loss allowance policies. The following sections of this chapter discuss key account management practices, including those addressed by the AMG. Subsequent sections discuss reporting and tracking associated with those functions.

ACCOUNT MANAGEMENT

Account management generally refers to any actions that the bank takes after a card account is originated and often in response to changes in cardholders' financial capacities. The changes can be brought about in several ways and may be for the better or for the worse. Account management encompasses the continual evaluation of accounts to identify and respond quickly to the changes in borrowers' financial conditions or behavioral patterns. The process is challenging because cardholders are not typically obligated to supply financial information after their accounts are opened.

Account management covers many activities and affects the amount and the length of time the bank makes credit available to the consumer. Adequately monitoring and managing account information necessitates effective strategies to handle the large volume of open-end credits and efficient information systems capable of generating reports needed to make on-going, timely credit decisions. Account management processes vary depending on the bank's size, level of automation, and staff expertise. They also vary depending on an account's status (for example, good standing versus a problem account) and on product type or cardholder attributes (for example, prime versus subprime accounts). But, no matter the program type or account status, regulators expect banks to have a means of identifying the current risk profile of portfolio(s).

Examiners' attention is warranted when banks substantially modify account management activities to accommodate affinity, co-brand, or other similar accounts. If account management practices for those types of programs diverge from the bank's typical practices, examiners normally call on management to readily support the reasonableness of such practices, including that such practices follow applicable regulatory guidance. Evidence should demonstrate that management's development and review of account management strategies includes all applicable functions, such as information technology, compliance, and finance.

The account management function can be handled with automated systems, manual systems, or a combination thereof. Most banks use automated systems which allow them to make decisions on a large number of accounts with minimal manual intervention, thereby reducing costs. Most automated systems use specific cardholder criteria established by management. For example, managers may identify borrowers within a range of credit scores that currently warrant a certain over-limit approval. Only those borrowers falling outside of the automated specifications would undergo potential manual intervention. For automated systems, examiners should evaluate management's practices for periodically validating scoring systems or other guidelines incorporated and verifying the accurateness of data entry. System settings that do not correspond to those described in the bank's policies and/or that do not provide for compliance with regulatory guidance illustrate circumstances warranting examiners' attention.

Non-automated systems require credit analysts to review the customer's risk profile and the bank's underwriting and policy guidelines for the decision-making process. While non-automated systems may be the only reasonable procedure available to many smaller banks, they can be costly. Non-automated systems call for control systems to ensure that analysts consistently follow policies and make informed decisions.

Supervisory review normally includes an assessment of the bank's account management techniques for identifying higher-risk accounts and adverse changes in account risk profiles. Identification of such matters assists management in implementing timely preventive and corrective actions. Effective account management generally includes:

- Periodically refreshing risk scores.
- Using behavior scoring and analysis to identify potential problem accounts.
- Assessing utilization rates.
- Assessing payment patterns, including borrowers who make only the minimum payments or who rely on the line to keep the account current.
- Monitoring collateral values.
- Obtaining updated collateral values when significant market factors indicate a potential decline in values or when the borrower's payment performance deteriorates, placing greater reliance on the collateral.

Concerns may appear when the frequency of these actions is not commensurate with risk in the portfolio. Further, any failures by management to fully test, analyze, and support its account management practices calls for elevated scrutiny during the examination.

Account management functions are often outsourced to third-parties. For example, customer service firms and collection firms are often used. The Third-Party Relationships chapter contains information on assessing third-party relationships.

Account management activities cover, but are not limited to, scoring, minimum payments, negative amortization, payment deferral programs, **pre-payment programs**, authorizations, over-limits, credit line management, renewals, collection activities, workout and forbearance programs, settlements, and re-aging.

Scoring

Failure to understand the current risk profile of cardholder accounts could lead to an artificially low level of identified credit risk which could translate into under-funded allowances and stress on liquidity, earnings, and capital. Issuers normally obtain a current risk profile on cardholder accounts by re-scoring accounts. Often, this is referred to as refreshing the credit score. In the past management typically obtained **refreshed credit scores** semi-annually or annually. However, quarterly and monthly refreshes are now common. By refreshing an account's credit score, management is able to identify apparent trends in the consumers' financial situation in the absence of updated consumers' financial information and potentially before any financial stress may be apparent based on the cardholder's internal performance. Within the bank's information systems and databases, both the original credit score and the refreshed credit score for each account are generally maintained to facilitate more effective risk management of the account and the portfolios. For example, the scores can be used in **migration analysis**.

More sophisticated institutions use behavior models in conjunction with credit scores. Similar to credit scores, behavior scores are refreshed on a regular basis. Due to expenses involved, smaller banks often do not use automated behavioral scoring systems. However, vendors continue to work to make these or similar systems more attainable for smaller institutions. Scoring models are discussed in the Scoring and Modeling chapter.

Minimum Payments and Negative Amortization

The amortization of principal balances is one of the key factors when determining whether a bank's credit card lending practices are safe and sound. As such, setting appropriate minimum payment requirements is a critical function of management. The failure of minimum payments to sufficiently amortize the debt in a reasonable timeframe not only elevates credit quality concerns and consumer protection issues but can also understate the level of delinquent accounts. Such an understatement could affect decisions made by parties interested in the financial conditions of the portfolio and the bank, including investors in securitizations of the portfolio.

Competitive pressures combined with desires to sustain outstanding balances and/or customer performance had led many banks to ease minimum payment requirements over time. Such easing often delayed principal repayment, thereby increasing credit risk and masking portfolio quality. While initially attractive to many consumers, the low payments often ultimately caused those consumers to face repaying a growing balance. The liberal repayment requirements resulted in negative amortization, a phenomena in which the outstanding balance owed on the card builds even though no new charges are made. The rising balance occurs because minimum payments fall short of covering all finance charges and fees assessed. The hazards of negative amortization are magnified when subprime lending is involved.

Further, programmatic, recurring over-limit fees and other charges often exacerbate the situation. In general, these types of fees are considered inappropriate when they are primarily aimed at increasing recorded income rather than at serving as a tool to enhance the borrower's performance or access to credit. Programmatic, recurring fees are typically defined as fees charged on an account as the result of the bank's fee program. These types of fee programs become problematic if they result in a cardholder's balance continuing to grow due to interest and fee assessments even if the cardholder meets subsequent minimum payment requirements. For example, if the bank has an over-limit fee program that assesses an over-limit fee every month an account is over-limit, even if the event that caused the over-limit occurred in prior billing cycles, yet the minimum payment does not require payment of the entire over-limit amount, the account balance would normally grow. Assume for this example that an account becomes over-limit by $100 and is assessed an over-limit fee of $30 at the end of the billing cycle. If the subsequent minimum payment required is not sufficient to cover the over-limit fee and the over-limit amount ($130) plus normal interest and fees, and the borrower only makes the minimum required payment (and thus, remains over-limit), the bank then assesses another $30 over-limit fee in the next billing cycle in accordance with its over-limit fee program. This type of program is clearly problematic since it results in continual fee assessments without requiring sufficient payment to cure the event that is resulting in the fee.

To address the liberalized minimum payment environment and the reality that minimum payments were not keeping pace with industry changes such as elevated line assignments; increasing and complex fees; and higher interest rates (risk-based pricing); the Agencies designed the AMG to specifically speak to minimum payments and negative amortization. The AMG calls for required payments to amortize the existing balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the debt and the borrower's documented credit-worthiness. Safety and soundness concerns arise when prolonged negative amortization, inappropriate fees, and other practices inordinately compound or protract consumer debt or mask portfolio performance and quality. When proper minimum payment requirements are not evident, examiners are expected to voice criticism and ask management to take proper and timely action which could include augmenting allowances, revising the design of minimum payment requirements, and/or altering their courses of action for fee assessments, depending on the situation.

According to the AMG, minimum payments should cover all finance charges and fees assessed during the billing cycle. Within the industry, fees included in minimum due requirements continue to vary. With the innumerable fees and ever-changing fee terminology evident in the industry, developing guidance specifically naming fees that would be consistently interpreted uniformly as well as would be comprehensive for all portfolio types would be difficult, if not impracticable. Rather, regulators generally allow management to look at the particular structures of the bank's products and set the minimum payment requirements for each product or segment in the context of those structures, as long as it amortizes the debt in a reasonable timeframe. A minimum payment method that is acceptable on one portfolio or segment might not be acceptable or reasonable for another portfolio or segment.

Because a uniform minimum payment structure has not been specified, minimum payment methods continue to vary. Some banks tier the total percentage due based on the outstanding balance. Several banks have designated an "equal to the greater of" approach where the balance due is the greater of a flat percentage of the outstanding balance, a flat dollar amount, or a certain percent of the balance plus interest charges and applicable fees.

Whatever minimum payment method(s) the bank uses, examiners should look for evidence that the method(s) provide for a reasonable amortization period. Interpretations of "reasonable amortization period" vary. Some banks require a one percent principal reduction per month in addition to payment of interest, late fees, and over-limit fees. Under that structure, a cardholder is generally required to demonstrate that he or she could amortize the debt in less than 10 years if he or she were to make the same dollar-level payments going forward. In reality, because the one percent principal reduction would be based on a declining principal balance (assuming no new charges are made), the amortization period is generally longer if, in subsequent months, the cardholder pays only the minimum due as requested by the bank. But, by making such payments, the cardholder proves that the ability to repay the debt in less than 10 years from that point exists. Minimum payment requirements that would not confirm a cardholder's ability to amortize the debt in less than 10 years or that are so small as to draw into question whether the borrower has the proper financial capacity likely warrant close review to determine how and whether such a payment structure meets the spirit and intent of the AMG. This is not to say that amortization periods that are greater than 10 years cannot be acceptable or that amortization periods of 10 years or less are automatically acceptable. Rather, it reflects that longer-term structures, such as those greater than 10 years, have generally shown higher propensities to increase credit risk and mask portfolio quality, and, as such, are usually considered as a starting point for examination analysis.

In any case, including whether it is occurring on a small or large scale, regulators are likely to object to programmatic negative amortization. The concept of programmatic negative amortization has been introduced in previous comments of this section, and in a broad sense, may be considered to occur when the card's fee and interest structure, as prescribed by management and as programmed into the bank's systems, results in negative amortization when combined with the card's minimum payment structure and the cardholder's normal behavior pattern. These cases could involve the assessment of charges, which sometimes could be purposefully regular and methodical, to a cardholder population that normally behaves in such a manner that the assessments combined with the population's payment and other behavior patterns produce rising balances over a short timeframe, even if the cardholder is meeting the account's minimum payment requirements. Fees also usually end up representing a disproportionate share of the balance.

Prior to the implementation of the AMG, many cardholders were making payments larger than the minimum due. These cardholders are likely experiencing minimal impacts from changes prompted by the AMG, and some (albeit the minority of) customers are even experiencing declines in payment required. However, some cardholders face higher minimums due and have found it a challenge to meet the higher requirements. To assist these customers and to control negative amortization, including from a programmatic standpoint, many lenders are modifying fee and interest structures. For example, some banks are decreasing interest rates and/or are waiving fees. Other banks are limiting the frequency of over-limit fees per each over-limit occurrence and are capping the number of late fees or other fees that tend to recur and, as such, often make up a disproportionate amount of the outstanding balance, especially in subprime portfolios. Examiners should evaluate how and to what degree the practices help the bank to meet the guidance, thereby assisting cardholders to reasonably amortize their debt and access credit. Examiners should pay close attention to lending decisions that do not factor in the customer's ability to repay the debt consistent with a reasonable amortization.

Management practices encouraged by examiners include periodically conducting negative amortization analyses on the credit card portfolio(s) to determine the prevalence of, and trends in, negative amortization. Many banks focus on identifying negative amortization that occurs based on payments made, sometimes considering the size of the payment. Analyses that consider cardholder performance can help management identify negative amortization that exists in the portfolio at that point in time for performing cardholders. However, if not structured properly, the analyses can be misleading and might not identify the true susceptibility to negative amortization. For example, if cardholders make payments larger than the minimum due, the analysis could indicate that negative amortization does not exist or is immaterial and, thus, could falsely lead management to believe its minimum payment structure is appropriate. If minimum payments are not sufficient to reasonably amortize the debt and if cardholders would have only paid the minimum due (rather than voluntarily submitting more than required), the level of negative amortization identified would be higher. More comprehensive analyses include not only negative amortization that is occurring based on payments made but also testing negative amortization that would occur if consumers only made the minimum payment as required. This analysis is more of a "what if" scenario.

Some bankers believe that late accounts should be excluded from negative amortization analysis because the lack of payment normally causes the account to negatively amortize, usually due to late payment or other assessments. However, considering late accounts in the analyses would expand the analysis pool available to determine whether or not negative amortization would have occurred if cardholders would have paid the minimum due. Further, an account could have been current and negatively amortizing and then falls delinquent during the month the analysis is conducted. In this case, delinquency could potentially be a symptom or result of negative amortization rather than a cause. If delinquent accounts are excluded, these types of accounts that are now delinquent but recently exhibited negative amortization even while current would be overlooked, depending on how the analysis is structured. Moreover, the AMG generally points to the inclusion of all fees (which would include late fees), or does not identify delinquent accounts as an exclusion to its guidelines. Regardless of whether or not payment is made and what the size of any payments made are, examiners should be concerned when the required minimum payment as prescribed by management is not designed to amortize the debt timely.

In addition to verifying whether proper minimum payment requirements have been established in policies and cardholder agreements, examiners should look for evidence that the bank's systems factor in proper minimum dues. If processing systems are not set correctly and/or if minimum payments are billed incorrectly, the bank might be under-reporting past dues. While these comments are not specifically addressed to partial payments, partial payments could constitute one example of how systems could be set inappropriately. A discussion about partial payments is housed under the Delinquency section of this chapter.

Payment Deferral Programs

Payment deferral programs allow cardholders to defer one or more minimum monthly payments and are also known as **skip payment programs** or **payment holiday programs**. Interest continues to accrue on the balance during the deferral period. Cardholders selected for a payment deferral program are usually notified by telephone, monthly statement inserts, or separate mailings. Normally these marketing efforts occur during high purchasing periods such as holidays or peak vacation periods. Some banks allow flexibility by offering the right to skip one or more minimum payments at any time during the year.

Before implementing payment deferral programs (or to continue offering payment deferral programs) management is expected to carefully weigh the customer base to determine whether these types of programs would be appropriate for the card program offered. Skip-payment programs generally should be only offered to the most credit-worthy customers, if offered at all. For example, subprime programs or small balance programs may be directed to individuals who have had trouble maintaining or who are trying to establish consistent, favorable payment performance. Payment deferral programs might not be appropriate in some of these cases.

Payment deferral programs interrupt the regular payment stream, diminish management's ability to monitor performance and promptly identify problem accounts, and might be to some degree counterintuitive to the spirit and intent of the AMG, particularly if resulting in prolonged negative amortization. As such, some banks have discontinued these types of programs. However, for banks that still use such programs, evidence should substantiate whether management has established clearly defined policies and procedures for determining the credit criteria for account selection and for program parameters, such as how often a cardholder can qualify and for how many payments. Management may also consider the impact of these types of programs in any amortization analyses it conducts. Their failure to monitor the program's success, regularly review accounts for performance, and periodically evaluate eligibility requirements is normally cause for concern as are deferred payment plans that are offered to cardholders who are anticipated to abuse the privilege and create safety and soundness problems.

Pre-Payment Programs

Pre-payment programs, or **pay-ahead programs**, are similar to payment deferral programs in that they allow the cardholder to skip one or more minimum monthly payments. However, these programs are targeted to cardholders who make payments in excess of the minimum monthly payment and entail the application of excess payment amounts to the next consecutive payment(s). Pre-payment programs vary. Some allow cardholders a zero minimum payment requirement until the pre-payment amount is exhausted, while other programs have set time limits. For example, a bank might only allow a zero minimum monthly payment for one billing cycle, regardless of whether the excess paid surpasses one minimum monthly payment.

Pre-payment programs in and of themselves might not be problematic, but have the potential to be counterintuitive to the spirit of the AMG. Similar to payment deferrals, they interrupt the payment stream and diminish management's ability to monitor performance and promptly identify problem accounts. Consideration of the impact of these types of programs in any amortization analyses the bank conducts may be helpful. Examiners should look for evidence that corroborates that before management implements pre-payment programs (or continues offering such programs) it carefully looks at the customer base to determine whether these types of programs are appropriate for the card program offered. Well-structured programs generally only offer the option to the most credit-worthy customers and are subject to clear guidelines, including identifying the maximum number of payments that can be skipped and monitoring the programs.

Credit Line Management

The AMG addresses credit line management, and in general, requires careful consideration of borrowers' repayment capacities when establishing or modifying credit lines. It also expects banks to test, analyze, and document line-assignment and line-increase criteria prior to broad implementation. In the past, many banks inappropriately used line assignments and line increase strategies to maintain asset growth and/or to mask poor portfolio performance (for example, using line increases to "cure" over-limits).

Initial Credit Line Assignment:

Initial credit line assignments are discussed in the Marketing and Acquisition chapter as well as the Underwriting and Loan Approval Process chapter. In summary, concerns normally arise when the initial line assigned is not commensurate with the consumer's willingness and ability to repay the credit under established, reasonable terms (which would include minimum payment and amortization configurations consistent with the AMG's guidelines). Situations where support for the line assignment does not include documentation of relevant credit decision factors or where management has not ensured that the level of available credit and card utility offered is reasonable and well-disclosed warrant close inspection.

Credit Limit Increases:

Similar to multiple account strategies, liberal line increase programs can increase the risk profile of a borrower quickly and can result in rapid and significant portfolio deterioration. Concerns normally arise if the bank does not have the capacity to fund the increased lines if drawn or has not carefully considered the borrower's repayment capacity, including any other accounts that the customer has with the bank. Most often, repayment capacity is determined with the use of scores and consideration of the borrower's performance history rather than income verification. Some banks charge a fee for increasing the credit line. Risks of improper management of line increases are that earnings could be unduly overstated and/or that the bank could be taking on credit risk that it cannot handle. According to the AMG, management should be testing, analyzing, and documenting line increase criteria prior to broad implementation.

Credit limit increases are normally prompted with management-initiated, system-wide automated programs or through cardholder requests. Most management-initiated programs use scoring models, behavior models, or a combination of both, to screen the cardholder base and determine the pool of eligible accounts. The systemic programs also usually consider other qualifying criteria, such as the time elapsed since an account's origination and/or since prior line increases, and usually incorporate champion/challenger strategies. With automated line increase programs, the increases are granted whether or not the customer needs or wants the increase. However, consumers may ask the bank to withhold their accounts from the automated strategies.

For customer-initiated line increase requests, banks process the requests as each is received. The process generally involves a credit analyst reviewing cardholder requests manually, making a determination based on prior credit history, the increase requested, and the bank's policies. Thus, in general, proper policies clearly establish approval criteria, specify the approval process, define verification steps, assign responsibility, establish lending authorities, and outline documentation requirements. Similar to management-initiated programs, scores and time elapsed since origination and/or prior line increases are usually considered. Section 112 of the FACT Act (and correspondingly, section 605A of the FCRA) provides that, for a credit line increase requested by a consumer whose credit report contains a fraud or active duty alert, the bank must use proper identification procedures regarding the identity of the person making the request. However, it is prudent to verify a consumer's identity even if no alerts are evident.

Examiners should direct their attention to situations in which management is increasing credit limits on accounts that fall below the cut-off credit score and/or other underwriting standards. Because sufficient time is necessary for the cardholder to demonstrate that he/she can handle the existing line amount in a consistent, satisfactory manner, examiners expect management to normally refrain from granting line increases shortly after an account's origination or shortly after another line increase was granted. As such, notably short seasoning periods (such as six months or less) usually are subject to elevated scrutiny to determine whether they are appropriate in the particular bank's situation. In general, main components of line increase policies include identification of:

- The approval process and approval criteria.
- Verification procedures.
- Lending authorities.
- Documentation requirements.
- Testing expectations.
- Limitations on the number of line increases per account
- Some type of limit (dollar or percentage or both) on the increase per line as well as seasoning (time lapse) criteria.
- A requirement that line increases outside of established criteria be reported on an exception list and reviewed by management on a regular basis.

Credit Limit Decreases:

Line decreases are generally based on evidence of adverse information, although some cardholders may request a line decrease. Credit limit decreases can be conducted manually or with an automated system. In the case of decreases prompted by adverse information, the credit lines are often reduced to the outstanding balance or to the nearest established increment above the balance at the time of the decrease (for example, to the nearest $100 above the outstanding balance). The increment method helps avoid a quick run into over-limit status when finance charge or other fee assessments occur shortly thereafter.

As stated in FIL-45-2005, *Home Equity Lending: Credit Risk Management Guidance,* banks should refuse to extend additional credit under, or should reduce the credit limit of, a home equity line when appropriate. Regulation Z (Truth in Lending) only permits such steps in certain circumstances, including, for example, when the collateral value declines significantly, when default of a material obligation under the loan agreement is evident, or when deterioration in the borrower's financial circumstances is evident. To freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, both of these conditions must be met: (1) there must be a material change in the borrower's financial circumstances, and (2) as a result of the change, the bank reasonably believes that the borrower will be unable to fulfill the plan's payment obligations.

Multiple Credit Lines:

The Underwriting and Loan Approval Process chapter talks about multiple account strategies. Due to added management requirements, granting multiple credit cards with smaller lines generally results in as much or more risk than granting a consumer one card with a higher line. The AMG expects banks that offer multiple credit lines to have sufficient internal controls and systems to aggregate related exposures and effectively analyze performance.

Authorizations

Authorization is the process of verifying that the card account has sufficient credit available to cover the amount of the transaction. The transaction's risk is assessed, and the process yields an approval, a decline, or a pending response in which the merchant must take additional steps, such as calling a toll-free authorization phone number. If the authorization is approved, the amount of the transaction is reserved on the card. In some cases, as with car rental companies and hotels, the exact amount of the transaction may not be known before the customer uses the product. In these situations, temporary holds are placed on the card accounts to provide merchants with a level of assurance that they will be paid for the services used.

The authorization process is structured to prevent transactions being approved for cardholders who have not satisfactorily maintained their account or who may be over-limit (and, hence, limits credit risk) and is also designed to protect against the unauthorized use of stolen or fraudulent cards. An effective authorization system allows good customers to make transactions within preset limits while preventing other transactions that pose undue risk to the bank. In most instances, banks automatically authorize transactions unless the transaction exceeds the authorized limit tolerance (either based on percentage or dollar amount), fraud is detected, or some other type of mismanagement is evident on the account. For example, a system might be set to authorize good customers to transact purchases up to five percent over their credit limit. If the purchase would put the cardholder at six percent over the credit limit, the authorization would be declined or might be referred for manual review. Authorization criteria beyond the normal credit limit, such as when a bank sets the system to allow certain cardholders to go a certain percentage above their credit limit, are sometimes referred to as expansion criteria.

Merchants process customer charges many ways, including but not necessarily limited to, a **paper-based transaction**, a dial-in terminal, or an electronic card reader. Clearing customer charges via paper sales drafts and dial-in terminals can be slow and costly. Speed and cost advantages prompt many merchants to use electronic card readers. The electronic networks enable virtually immediate authorization for most point-of-sale transactions. And, while most use electronic networks, the authorization process differs depending on merchant and transaction type. For example, for restaurants, an authorization might be obtained for the total check amount and a preset authorization tolerance. If the customer provides for a gratuity beyond what the preset authorization would cover, an additional authorization must be obtained. For card-not-present transactions (such as for mail or phone orders), other processes, such as address verification, are incorporated.

Authorization systems vary but commonly intend to provide reasonable assurance that charges are only authorized within prescribed credit limit tolerances and that accounts are appropriately blocked to prevent future authorizations when fraud is detected. Regardless of the authorization process used, examiners normally look for evidence that:

- Management has adequate policies and procedures in place that reflect the bank's risk tolerances.
- Management regularly reviews and updates the policies and procedures as needed.
- Sufficient controls exist to monitor adherence to the policies.
- System settings are consistent with the bank's policies.

Renewals

General purpose credit cards have pre-set expiration dates, usually two to three years after issuance. Expiration dates have generally lengthened not only to help reduce expenses that accompany renewal but to help control fraud by limiting the volume of cards within the mail system. Although cardholder accounts are evaluated for creditworthiness periodically throughout the account relationship, the expiration date gives management the right not to renew (or reissue) the account relationship at that time (and, hence, the ability to control credit risk). In general, proper written credit and performance guidelines establish credit criteria, consider the length of the relationship, and include performance criteria such as average outstanding balance, usage rate, payment and delinquency patterns, and account profitability. Normally, the renewal process is automated, uses scoring and behavior models, and is applied to the entire portfolio. Examiners should analyze management's practices for periodic testing of the integrity of the system and evaluating the effectiveness of renewal strategies.

Customer Service

Customer service encompasses a wide variety of activities, including, but not limited to, activating cards, initiating balance transfers, and handling account inquiries. Customer service can be conducted through written correspondence but is more often conducted via phone and increasingly online.

Consumer Complaints and Litigation:

The customer service area might identify consumer complaints. Complaints can serve as an early warning signal for compliance, credit, and operational issues, including discriminatory, unfair, deceptive, abusive, and predatory practices. Concern is normally warranted when banks are not prepared to handle consumer complaints promptly, including maintaining well-defined procedures. Recognition of bank staff responsible for handling the complaints that is broadcast to all bank staff can help expedite referrals.

Failure to be sensitive to complaints can ultimately result in litigation (and hence, potential financial and reputation implications) or eventually result in legislation that is broader, more rigid, and more restrictive than was the particular practice that brought the complaint. Even if legal at the time, a bank's policies and practices may prompt objections that lead to new regulations.

As mentioned in the Identifying Involvement in Credit Card Activities chapter, the FDIC's Consumer Response Center is a source available to examiners to help identify the volume and types of complaints that consumers are bringing against the bank. Evidence gathered during the examination should help form an assessment as to whether or not management closely monitors complaint activity. Such evidence often involves complaint and litigation logs. The bank most likely only hears from a small proportion of its dissatisfied customers. Consequently, the impact of the potential problem may be much more far-reaching than a simple review of the volume of complaints might suggest. The type of complaint, therefore, is also very important to consider when assessing the level of risk.

Closures and Retention:

Many account closures occur voluntarily (the customer requests to close the account). Retention programs are critical to relationship management and in controlling attrition. With the credit card market remaining highly competitive, banks generally try to retain accounts when possible and when it would benefit the bank. If retention programs are not properly structured, **adverse retention** could occur. Monitoring the performance of retained accounts helps management detect adverse retention and determine whether retention practices are appropriate and effective.

Account closures may also occur involuntarily, usually when the cardholder mismanages their account. For example, the account may be delinquent or over-limit when it is closed by the bank. The remainder of the Account Management section focuses on the management of these types of higher-risk accounts, which is generally referred to as collections.

Collections (General)

Collection activities serve to control and minimize credit card debt losses. In the past, collection activities have mainly focused on delinquent and over-limit accounts. However, more and more, management is identifying a need to spot potential warning signs for current accounts that may wind up in collections in the future. As debt-to-income ratios mount, it becomes more difficult for management to predict how a delinquent account will behave without sophisticated analytics. It is even more challenging to predict how a current account will behave. As such, sophisticated analytics capable of scoring individual accounts against specific treatment strategies and the resources available to apply those strategies are being deployed to not only address accounts already evidencing higher-risk (such as delinquent or over-limit) but also to head off delinquency or other problems for current accounts likely to become higher-risk. Early intervention on such accounts could significantly reduce the bank's costs (and, hence, impact earnings) in the future.

Changes in underwriting standards, saturation of the card industry, escalation in bankruptcies, and stagnation in some geographic regions have heightened the need to carefully attend to collection practices. In addition, consumers often consider non-secured loans a low priority. Problems created by poorly-managed collection processes include, but are not limited to:

- Abuse of re-aging or other programs to mask delinquency and loss, which may also result in untimely, inaccurate management reports and inadequate loss allowances.
- Failure to maximize recoveries.
- Violations of laws or regulations.
- Reduced earnings due to increased losses, lowered recoveries, or assessed fines. Some banks have been ordered to pay large restitution and penalties for engaging in poor business practices, including deceptive or abusive collection practices.
- Reputation and legal risk, such as when collection activities are not consistent with regulations.

The management and structure of collection activities vary depending on the bank's size as well as its available technology and expertise. Internal collection departments normally include one or more collection supervisors, and management monitors those supervisors to ensure they routinely review collectors' performances. Assessments of collector performance are usually based on a number of factors which, in general, include the number of accounts per collector, the number of contacts made, average time per contact, and dollars collected (as opposed to dollars promised). The optimum number of accounts per collector varies depending on factors such as the technology employed, type of account, and stage of delinquency. Potential negative ramifications of ineffective employee compensation programs include, but are not limited to, encouraging protracted repayment plans and aggressive account re-agings.

Collections are sometimes outsourced to collection agencies. The Third-Party Relationships chapter talks about general outsourcing controls, including due diligence processes and contract provisions. Forward-flow contracts are sometimes established. They provide the third-party agencies with a set number of accounts at a determined frequency and assist management with forecasting collection placements. Concerns with outsourcing arrangements may include cases where the outside firms fund loan payments to cure delinquencies and thereby mask poor collections performance on their part or poor initial credit risk selection on the bank's part.

Collection strategies are not static and are not uniform across all banks. The growing size and complexity of the credit card business, along with the labor-intensive nature of collections, makes the collections function increasingly difficult to manage. Specialized, state-of-the art technology such as complex automated dialing systems and intricate skip tracing tools is frequently used to optimize productivity and control overhead costs. The collections area also frequently uses champion/challenger strategies.

Collection strategies generally attempt to direct efforts to those accounts with the greatest risk of loss and the greatest potential for collection. Ineffective strategies could result in reduced collections (and, thus, reduced earnings and liquidity). Some banks use scoring models to help predict the likelihood of collection and then employ collection practices such as phone calls, collection letters, legal letters, statement messaging, or enrollment in repayment programs, depending on the severity of the delinquency and what the score indicates. Successful subprime lenders have historically employed heightened collection efforts, such as calling delinquent borrowers more frequently, investing in highly-complex technology, and assigning more experienced collection personnel to seriously delinquent accounts. Collections for subprime lending is very labor intensive but critical to the program's success.

Fee waivers are sometimes used as a collection tool. Collections personnel attempt to entice consumers to pay by surrendering or reversing certain fees. Often, the customer might be persuaded to pay more when fees are waived. Fee waivers are normally governed by policies that give clear guidelines as to acceptable limits on the level of fees waived (by dollar and/or percentage) as well as the types of fees that can be waived. The level of fees forfeited may be tied to collectors' compensation packages (with fee waivers reducing compensation to some degree). In this respect, collectors using fee waivers as a tool are not inclined to abuse such practices, where the abuse could substantially impact the institution's earnings (both due to fees lost and to potentially excessive compensation paid). Along the same lines, collection departments may focus on **promises kept** measurements as compared to **promises to pay** measurements when establishing incentive pay programs because a wide disparity sometimes exists between the volume of payments or dollars actually received from cardholders compared to the volume promised by cardholders.

Collection activities encompass, but may not be limited to, over-limit accounts, delinquent accounts, charge-offs and recoveries, re-pricing, re-aging and various cure programs such as workout programs. The following sections discuss each of these areas.

Over-Limit Accounts

When an account is over-limit, it means that the account's balance has surpassed the account's credit limit, due to purchases or other assessments, such as fees. Over-limit authorization requests occur either by the cardholder contacting the bank or more frequently by the cardholder attempting to make a charge through the payment network. Customer-initiated requests can be routed to a credit analyst where, based on the credit analyst's lending authority and the account's history, credit score, or other criteria, the transaction is approved or denied. In many cases, over-limit approvals for purchases are automated rather than manually reviewed. Advanced systems use behavior scores, adaptive controls, and management's parameters to approve or deny over-limits without human involvement. In addition, a combination approach is sometimes used. Authorizations up to a pre-set dollar amount or percentage above the credit line (expansion criteria or buffers) might be handled by automated systems, and transactions falling outside the expansion criteria would be referred for manual review or in some cases, automatically declined. Even with reasonable authorization parameters set, certain instances can occur in which authorization is granted above the credit limit or even beyond established expansion criteria. For example, "variable amount" and "under the **floor limit**" charges can result in charges above an account's established credit limit or above the expansion criteria.

A bank's authorization practices could be a contributing factor in causing over-limits. Failure to establish proper guidelines for when and under what conditions over-limits will be granted could result in increased credit risk. Over-limit authorizations on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls.

Examiners should direct their attention to practices whereby line increases are used to mask over-limit statuses. Further, without proper controls for handling payments returned for insufficient funds and for handling large-payment holds, these items can prematurely create available credit because only later (when the insufficient funds payment is returned) would the payment credit be reversed. In the mean time, the cardholder would have the opportunity to use the inflated available credit for purchases. Then, after reversal of the payment application, the cardholder could easily be over-limit to a degree which normally would not have been approved.

Prudent over-limit practices are important for all credit card accounts, including both prime and subprime accounts. When a bank's fee assessment practices are designed to compound fees and other charges in order to trap its customers in a cycle of pyramiding over-limit debt, supervisory attention is warranted. Cases where cardholders go over-limit as a result of fees being assessed on their accounts have the potential of happening more often when the credit limits are small, such as with subprime accounts. In these cases, the account holders might go over-limit shortly after opening the account, especially when a small credit line is largely consumed by upfront fees leaving limited utility at account inception. When credit lines are small, the assessed over-limit fee(s) usually result in the over-limit balance being very high in proportion to the established credit line. No matter what size the credit lines are, fees are usually contributing factors to the level of over-limit balances.

Some banks notify customers ahead of time of upcoming fee assessments, such as annual fees, such that the cardholder would have time to remit payment(s) to free up available credit to cover the upcoming assessment. Once an account is over-limit, some banks take steps to reduce the impact of fee assessments. For example, some banks do not allow a late fee to trigger an over-limit fee if the late fee is what makes the account over-limit. Other banks cap the number of over-limit and/or other fees that can be assessed or suspend over-limit and other fee assessments in certain cases, such as when an account reaches a certain past-due status. The waiving or capping of fees is intended to help control the level of the over-limit amount and, thus, hopefully help and motivate the customer to pay off the over-limit balance in a timely manner as well as retain a reasonable amortization timeframe.

The AMG points out that practices that do not provide for timely repayment of over-limit amounts can significantly increase the credit-risk profile of the portfolio, and the increase is often magnified for subprime portfolios. It also notes that deficient reporting and loss allowance methods as a result of imprudent over-limit practices can understate credit risk. All banks are to carefully manage over-limit practices and focus on reasonable control and timely repayment of amounts that exceed established credit limits. In accordance with the AMG, examiners should look for proof that management's objective is to ensure that the borrower remains within prudent established credit limits that increase the likelihood of responsible credit management. The *Home Equity Lending: Credit Risk Management Guidance*, which would be applicable to home equity credit card lenders, declares a similar position to that of the AMG.

The regulatory guidelines are written broadly to allow banks flexibility. Clearly fee structures, products, authorization strategies, and portfolio dynamics differ among banks, and absolute, un-flexible guidance would most likely not be reasonable or effective for all portfolios.

Examiners should assess management's practices for ensuring over-limit accounts are repaid in a timely manner. Those practices generally include formalized (or defined) repayment programs that require cardholders to repay over-limit balances in a structured fashion. When an account goes over-limit, management might initially utilize techniques such as calling strategies and letter campaigns to attempt to get the cardholder to bring the account back within its established credit limit. Also, the cardholder's monthly payment due generally includes over-limit amounts, either in total or based on a structured pay-down that, if paid, would result in the timely repayment of the over-limit amount. In general, a bank's practices should strive to limit the dollar volume and number of chronic over-limit accounts. In some cases, chronic has been considered to be seven or more consecutive months. Failure by management to monitor the volume (dollars and number) of over-limit accounts, including appropriate segmentation to identify trends in chronic and non-chronic populations, is cause for concern. High or increasing volumes of over-limit accounts and/or balances, especially those considered chronic, suggest that the bank's over-limit controls and programs may not be effective. For the most part, the volume of over-limit receivables has declined since the AMG was issued. However, it still perpetually requires close attention and appropriate controls.

Reporting of over-limit statistics is sometimes unclear or confusing. For example, reports sometimes only reflect accounts that are over-limit and current and might exclude accounts that are both over-limit and delinquent. Reports may be segmented based on the severity of over-limit amount, such as less than 10 percent over-limit, 10 to 20 percent over-limit, and so forth. This type of information provides management with further information to assess the severity of over-limit amounts and compliance with policy parameters. The examination's evaluation of over-limit practices considers both accounts that are over-limit and current as well as accounts that are over-limit and delinquent. Delinquent accounts (which might or might not be over-limit) are discussed next.

Delinquent Accounts

Delinquencies are a primary indicator to consider when assessing the quality of card portfolios. Delinquency rates change constantly due to fluctuation in consumer behavior patterns and changes in general economic conditions. Rising delinquencies are usually the first sign of credit deterioration. The level and trend of the delinquency rate combined with projected loan growth can give an indication of potential charge-offs which, in turn, impact earnings and capital. As such, delinquency status is often the primary segmentation tool used in credit card loss allowance methods, as discussed in the Allowances for Loan Losses chapter.

For regulatory reporting purposes, banks are to report the full amount of the credit card receivables that are past due, not simply the delinquent payment amounts. Past due status should be determined in accordance with contractual repayment terms. Grace periods allowed after the loan technically has become past due but before the imposition of late charges are not to be taken into account in determining past due status. Open-end credit cards are to be reported as past due when the customer has not made the minimum payment for two or more billing cycles. Closed-end credit card loans that require scheduled monthly payments are to be reported as past due when either principal or interest (or both) is unpaid and is in arrears two or more monthly payments. However, at a bank's option, they may be reported as past due when one scheduled payment is due and unpaid for 30 days or more.

The term **delinquency bucket** is often used when referring to delinquent accounts. Buckets are generally described as periods of about 30 days. For example, there is a current bucket, a 1 to 29 days delinquent bucket, a 30 to 59 days delinquent bucket, a 60 to 89 days delinquent bucket, and so on. Sometimes banks refer to buckets as bucket one, bucket two, and so forth.

When a cardholder fails to make his or her first payment due on the credit card account, it is typically referred to as a **first payment default**, or first-pay default. First-pay defaults can be segmented into two categories:

- No-use, no-pay accounts - the cardholder has not made any purchases or cash advances and did not make the first payment due (where payment due is prompted by fees or other upfront charges assessed to the card).

- Use, no-pay accounts - the cardholder has used the account to make purchases or cash advances and has not made the first payment.

The two categories can represent very different types of risk, but the risks of these accounts are not mutually exclusive. In the case of no-use, no-pay accounts, the consumer could be suggesting (by not remitting payment) that they did not understand the fees being assessed to the card upfront or that they no longer want the card (possibly due to its fees). Either of those scenarios might suggest compliance and/or reputation risk. Or, financial stress may be preventing the cardholder from making the first payment due. With no-use, no-pay accounts, the bank generally has not lost cash because no payment has been made to merchants. Rather, if the account never pays, the bank would have lost costs incurred in originating the account. However, in the case of use, no-pay accounts, the bank has remitted payment to merchants for the purchases, and if the cardholder does not pay, the bank will not recover the amount given to the merchant (unless the transaction is subject to charge-back). Use, no-pay accounts might be an indication of fraudulent activity. Or the lack of payment may be due to financial stress. If that is the case, it may suggest flawed underwriting criteria, particularly if the volume is substantial. Subprime portfolios usually reflect higher rates of first-payment default than do prime portfolios.

Collection strategies for delinquent accounts vary, often depending on whether delinquency is considered early stage or late stage and on the type of account. Typically, accounts in earlier delinquency stages require less collection effort than those in later stages. Early-stage collection efforts often include statement messaging and letters to the cardholder. Later-stage collection efforts usually consist of frequent calls to the cardholder and may also encompass enrollment in defined repayment programs that are discussed later in this chapter. Accounts that are both over-limit and delinquent generally require strong collection efforts as do subprime accounts.

The examiner's evaluation of past due loans may incorporate the Lagged Delinquency Ratio which is the ratio of credit card loans that are past due 30 days or more plus those credit card loans on non-accrual measured against total outstanding credit card loans on a three quarter lag (total outstanding loans approximately 270 days, or three quarters, prior to the current period). It is particularly helpful when a bank has experienced rapid growth. A large volume of new loans being booked can mask credit problems by artificially lowering the current delinquency ratio as new loans (which would not yet be delinquent) are added to the denominator. A relatively high ratio can be an early warning sign of weak underwriting standards and potential future delinquency problems as the loans season.

The accuracy and integrity of the bank's system for reporting past due credit card loans is critical to the proper and timely identification of credit risk. The examiner's evaluation of past dues and the associated credit risk considers the bank's partial payment, non-accrual, and re-aging practices, as well as the volume and trends of delinquencies. It also considers whether minimum payments are sufficient to reasonably amortize the debt.

Partial Payments:

The *Uniform Retail Credit Classification and Account Management Policy* (Retail Classification Policy) and Call Report instructions address partial payments. A payment equivalent to 90 percent or more of the contractual payment due may be considered a full payment in computing past due status. Alternatively, the bank may aggregate payments and give credit for any partial payment received. For example, if the payment due is $40 per month and the borrower makes payments of $20 per month for a six-month period, then the loan would be $120 ($20 shortfall times six months), or three full months, past due. A bank can use either or both of the methods in its portfolio but may not use both methods simultaneously with one loan. Improper partial payment practices could mask delinquencies and losses.

Non-accrual:

Regulatory guidelines do not require consumer loans (including credit card loans) to be placed on non-accrual status when principal and interest remain unpaid for 90 days (nor do they require a similar loan secured by a 1-4 family residential property, such as a home equity credit card, to be put on non-accrual status). However, these loans are subject to alternative methods of evaluation to assure that the bank's net income is not materially overstated. Management's non-accrual practices are evaluated on a case-by-case basis.

Proactive non-accrual policies provide a more accurate and timely reflection of actual operating performance. Examples of proactive policies include placing accounts on non-accrual status when the account becomes 90 days past due, when the cardholder enrolls in a **Consumer Credit Counseling Services (CCCS)** program or workout program, or when the borrower threatens to file for bankruptcy protection. These types of policies can be encouraged; but, the lack of them is not necessarily grounds for criticism. Some credit card servicing platforms do not have the capability to place individual loans on non-accrual. To the extent that a bank elects to carry loans as non-accrual on its books, the bank must also report those loans as non-accrual on its Call Report. Furthermore, when one of a borrower's loans is assigned to non-accrual status, any other loans outstanding to that borrower should be evaluated to determine whether one or more of them should also be assigned to non-accrual status. Lastly, state statues, regulations, or rules that impose more stringent standards for non-accrual of interest take precedence.

Re-aging:

Re-aging is technically defined as returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that is contractually due. It generally refers to the removal of a delinquent account from normal collection activity after the borrower has demonstrated over a specified period of time and through some degree of performance that he or she is capable of fulfilling contractual obligations without the intervention of the collection department. It is viewed as one method of helping borrowers overcome temporary financial difficulties, such as job loss, medical emergency, or change in family circumstances, and is meant to be used for borrowers who have the capacity to satisfactorily service their debt, but are unable to catch-up on prior delinquency. Re-aging is often referred to as curing or rolling-back an account and is intended to prevent the account from remaining perpetually delinquent. A few banks continue to re-age on an exception basis, and some banks re-age manually. However, most banks re-age as a regular practice and use automated systems to complete the re-ages. While re-aging practices are usually reviewed during the examination, cases where re-agings total a sizable percentage of accounts (such as more than five percent) or have unexplained spikes should be even more carefully looked into.

Overly lenient practices can cloud the true performance and delinquency status of accounts and, potentially, of the card portfolio as a whole. Improperly managed re-aging practices can result in understated charge-offs and can impede accurate analysis of loss allowances. As such, establishing clearly defined policy guidelines and parameters for re-aging is critical, as are ensuring the reasonableness of those guidelines and monitoring their effectiveness. Other important practices for management include monitoring both the number and dollar amount of re-aged accounts, collecting and analyzing data to assess the performance of re-aged accounts, and determining the impact of re-aging practices on past due ratios.

The Retail Classification Policy governs re-aging. According to its provisions, an open-end account can be considered for re-aging if:

- The debtor has demonstrated a renewed willingness and ability to repay the loan,
- The account has existed for at least nine months, and

- The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. (Funds may not be advanced by the bank for this purpose.) This requirement may be satisfied in any one of three ways:
    - Receipt of three consecutive monthly payments. For example, if the minimum due is $20, the cardholder would have paid $20 in month 1, $20 in month 2, and $20 in month 3.
    - Receipt of a cumulative amount equating to three minimum monthly payments within the three month period, regardless of the size or timing of the payments. For example, if the minimum due is $20, the cardholder could have paid $15 in month 1, nothing in month 2, and $45 in month 3.
    - Receipt of one lump sum equal to or exceeding three minimum monthly payments. For example, if the minimum due is $20, the cardholder would have paid a lump sum of $60.
- For an over-limit account, all of these conditions must be met:
    - The account meets the other re-aging criteria.
    - It is re-aged at its outstanding balance.
    - No new credit is extended to the cardholder until the balance falls below the pre-delinquency credit limit.

Adequate information systems should identify and document any account that is re-aged, including the number of times such action has been taken. The Retail Classification Policy states that an open-end account should not be re-aged more than once within any 12-month period and no more than twice within any five-year period. In addition to the one time per year/two times per five year rule, a bank may re-age an account after it enters a workout program. Re-aging for workout purposes may only occur after receipt of three minimum consecutive minimum payments, or the equivalent cumulative amount, as agreed upon under the workout program. Re-aging for workout purposes is limited to once in a five year period. Banks may also adopt re-aging standards more conservative than those identified in the Retail Classification Policy.

The decision to re-age, like any other modification to the contractual terms, should be well-supported. Documentation should normally show that the bank's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the bank personnel confirmed that the borrower has the ability to repay the loan. However, with the use of auto-re-aging, the borrower's willingness is usually less clearly documented. In general, meeting the three payment requirement has been considered adequate to demonstrate both the ability and willingness to repay. While this practice may be considered acceptable, it also emphasizes the need to segregate the auto-re-aged population from the manually re-aged population for the purpose of being able to monitor performance of the two populations independent of one another. Management can also take other actions to augment and support the auto-re-aging process. For example, as a good faith effort, some banks send a letter to the cardholder in an attempt to ensure ability and willingness and to provide for contact should the cardholder wish to discuss the transaction. Some banks also review current credit reports and behavior scores to assess a borrower's capacity. If the quality of the auto-re-aged population shows continued deterioration, the practice of auto-re-aging may be considered to be imprudent and cited as such by examiners. For example, if a high percentage of auto-re-aged accounts return to delinquent status and/or go to charge-off, management's policy and procedures may be overly liberal and ineffective. The same holds true for the performance of manually re-aged accounts.

Examiners should review management's re-aging practices and the volume of accounts and receivables re-aged. In doing so, they may consider the Dollar Volume of Re-aged Accounts to Total Credit Card Loans on a Three Quarter Lag Ratio. Combined with delinquency and loss rates, it indicates the level of accounts that have experienced difficulty meeting minimum payment requirements. If relatively high, this could indicate management's aversion to recognizing losses.

Re-Pricing

Re-pricing is the process by which finance charges and/or fees (most often finance charges) are adjusted to reflect perceived changes in the risk-profile of the account. Re-pricing initiatives can include bureau-based, performance-based, or other initiatives. Re-pricing is often used to adjust pricing upward as a collection strategy and is frequently referred to as **penalty pricing**. Penalty pricing generally is used to offset collection costs (as compared to other fees which may be primarily intended to help the institution invest in technology, expand **Automated Teller Machine (ATM)** networks, or address other initiatives).

Bureau-based re-pricing refers to finance charge changes made to accounts based on changes in borrower credit-worthiness identified through shifts in credit bureau scores or other credit bureau information. As such, it is tied to the customer's performance with all creditors. While the technique can be used to adjust the pricing down or up, it is most often used to increase pricing.

Performance-based re-pricing refers to finance charge changes made in response to borrower performance on the account with the issuing creditor. The strategy typically relies on internal behavior scores and delinquency patterns, but may also incorporate a number of factors including line utilization and bureau score. Like bureau-based analysis, performance-based analysis can be used to increase or decrease charges, but is most frequently associated with default price increases. When employed for delinquent accounts, there is often a provision to return to a lower finance charge following a specified period of sustained on-time payments.

Increasingly, banks are running periodic analysis of their portfolios and changing the terms of individual loans based on the results. For example, some banks have determined that certain yields have not been sufficient to offset risk, so they have implemented aggressive up-pricing campaigns. **Universal default** provisions have also become popular and subject consumers to upward pricing for various reasons. For example, a declining credit score can cause default pricing to kick-in. In addition, paying other credit obligations late or one of many other factors can also cause default-pricing to kick in. In some cases, these re-pricing practices may drive away good customers, leading to a concentration of higher-risk accounts. Examiners should determine if re-pricing initiatives received thorough and controlled testing before full implementation and how the re-pricing initiatives impact the portfolio and the bank's performance.

Not all re-pricing occurs as a result of adverse trends in the consumers' profile. For example, some institutions offer graduation programs that reward sustained successful performance of higher-risk borrowers by moving them from a subprime-type account (typically a low credit limit with a high price) to a more traditional or mainstream product that would have a lower interest rate, lower overall fees, and/or a higher credit limit.

Examiners should assess management's internal controls and on-going monitoring of re-pricing initiatives. Provisions of re-pricing policies and procedures generally include:

- When re-pricing initiatives can be instituted.
- The length of time an account will stay re-priced before being re-evaluated for additional price changes (either upward or downward).
- Remedies for cardholders who remain delinquent despite being penalized.
- Any other additional requirements of the cardholder.

Examiners may encounter accounts that are subject to the *Soldiers' and Sailors' Civil Relief Act of 1940* (SSCRA). The SSCRA addresses service members' credit obligations that were incurred prior to active military duty and that service members are unable to meet due either to their absence from home or from the financial consequences of significantly lower military pay in comparison to pay received for their normal (civilian) employment. The SSCRA does not apply to any obligation entered into by a borrower after their military service has commenced. Some key provisions of the SSCRA include:

- Applies to all persons on active duty in military service of the United States as well as to certain dependents of those service members and certain other liable individuals.
- Requires no specific form of notice to creditors, but sufficient proof of entry to military service is to be retained in creditors' records.
- Provides for re-pricing, limited to a six percent interest rate cap, effective upon commencement of active duty regardless of when the creditor is notified. Interest charges in excess of the limit are to be forgiven and may not be collected after the customer is released from active duty.
- Burden of proof is on the bank to show that the borrower has not sustained a material impact from active duty status (and thus may not be subject to the rate cap).

The SSCRA is discussed in FIL-134-2002. Management normally consults with legal counsel about the SSCRA and with its external accountants about applying the provisions of the SSCRA.

Repayment Plans

Banks have instituted various repayment plans such as workout plans, temporary hardship programs, and Consumer Credit Counseling Services (CCCS) programs. The object of these programs is to collect the amount due and improve the borrower's subsequent performance. Banks are encouraged to work with borrowers on a case-by-case basis keeping in mind that use of these types of repayment programs to defer losses or to mask poor initial credit risk selection practices is improper.

Workout Programs:

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 is considered a workout credit. Generally, the repayment terms require amortization of the balance owed over a defined period. These arrangements are typically used when a customer is either unwilling or unable to repay the account in accordance with its original terms but shows the willingness and ability to repay the account in accordance with modified terms and conditions. Workout programs are generally directed at cardholders with longer-term moderate to severe credit problems. Temporary hardship programs which are intended to help borrowers overcome short-term financial difficulties are not considered workout programs unless the program's duration is longer than 12 months (including renewals).

Characteristics of improperly managed workout programs include liberal repayment terms with extended amortizations, high charge-off rates (although loss rates on workout programs are normally higher than loss rates on the remainder of the credit card portfolio because of the cardholders' weakened financial conditions), moving accounts from one workout program to another, multiple re-agings, and poor reporting of program performance. Repayment terms for workout accounts vary widely and sometimes have not included sufficient reduction of interest rates to facilitate timely repayment and assist borrowers in extinguishing the debt. In some cases, reduced minimum payment requirements coupled with the continued assessment of fees and interest extended repayment well beyond reasonable timeframes.

To address these problems, the AMG set workout program parameters. Per the AMG, the design of workout programs should maximize principal reduction and generally strive to have borrowers repay debt within 60 months. To meet these guidelines, banks might have to substantially reduce or eliminate interest rates and fees such that more of the payment is applied to reducing the principal. In addition to clearly documenting any exceptions to the AMG's guidelines, including compelling, supporting evidence that eased terms and conditions are warranted, management should have policies and procedures specifying:

- When workout programs can be used.
- Terms of the agreement.
- Remedies for cardholders who do not fulfill the agreed upon payment obligations.
- When and if accounts can be re-aged.
- And any additional requirements of the cardholder.

Examiners will also confirm whether management has instituted strong internal controls and on-going monitoring for determining if the programs are effective and beneficial.

The Dollar Volume of Workout Credits measured against Total Credit Card Loans on a Three Quarter Lag may be considered during the examination. Combined with delinquency, loss, and re-aging rates, the ratio indicates the level of accounts which have experienced difficulty meeting minimum payment requirements. If relatively high, this could indicate management's aversion to recognizing losses. Where workout programs are not managed properly, examiners should criticize management and require appropriate corrective action, which may include increasing loss allowances, accelerating charge-offs to an appropriate timeframe, and revising the design of the bank's workout programs for future entrants.

Temporary Hardship Plans:

Temporary hardship programs are designed for borrowers with specific, short-term difficulties and who are expected to return to satisfactory performance in a relatively short time. As mentioned, most temporary hardship plans are not considered workout programs for purposes of the AMG. Accounts are adjusted back to the original repayment terms when the agreed-upon term is completed or when the account is dropped from the program due to missed payment.

Consumer Credit Counseling Service (CCCS) Plans:

CCCS is a third-party, nonprofit organization designed to assist consumers who have on-going delinquency problems. A consumer's acceptance into the program is based on a CCCS counselor's determination that the consumer's financial situation is salvageable. Under the direction of the CCCS counselor, the cardholder is required to establish and adhere to a budget as well as make debt payments. Debt payments are remitted to CCCS which then submits the payments to the bank according to the negotiated terms. The negotiated terms can vary from full payment to significant reduction in payments of principal and interest. When a consumer is accepted into CCCS, collection procedures cease. The bank may elect to waive late charges or any other fees. The account may also be re-aged (if it meets the appropriate criteria) and/or may be put on non-accrual. If a cardholder fails to pay as agreed under the program, the agreed-upon terms revert back to the account's contracted terms and collection procedures resume. Examiners normally determine whether management has established policies and procedures to monitor and evaluate accounts in the CCCS program and has accurately reported and sufficiently accounted for CCCS accounts in allowance calculations.

Settlement Agreements

In lieu of repayment plans, banks sometimes negotiate settlement agreements with borrowers who are unable to service their unsecured open-end credit. Settlements are also known as debt forgiveness programs. In a settlement arrangement, the bank agrees to forgive a portion of the amount owed, and the borrower agrees to pay the remaining balance with a lump-sum payment or with defined payments over a specific short period. Well thought out policies, in general, limit the amount (dollar or percentage) forgiven and establish guidelines for repayment timeframes. Further, they provide for the establishment and maintenance of adequate allowances for accounts subject to settlement arrangements. Actual credit losses on individual consumer loans should be recorded when the bank becomes aware of the loss and, in general, the amount of the debt forgiven in a settlement arrangement should be charged-off immediately. However, immediate charge-off may not always be practical. In those cases, banks may treat amounts forgiven as specific allowances, and upon receipt of the final settlement payment, charge-off deficiency balances within 30 days. Generally, if a cardholder who is settling an account has more than one account at the bank, all of the customer's accounts should be considered for settlement. Clearly, the inability of the customer to perform under the contracted terms of one account suggests the potential inability to perform on the other accounts as well.

Charge-Offs

Loss rates are a reflection of credit underwriting and marketing efforts. They also reflect economic conditions and other external factors. Common drivers of credit loss include rapid growth or poor origination strategies that have resulted in adverse selection. High levels of subprime lending also drive loss rates up.

Credit card loans are charged-off when they are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. Charge-off does not mean that the credit card loan has absolutely no recovery or salvage value but, rather, that it is not practical or desirable to defer writing off this basically worthless asset even though partial or full recovery may eventually occur. While credit card losses for individual credit should be recorded when the bank becomes aware of the loss, in no case should charge-off exceed the timeframes stated in the Retail Classification Policy:

- For open-end accounts, when the account becomes past due 180 cumulative days from the contractual due date.
- For closed-end accounts, when the account becomes past due 120 cumulative days from the contractual due date. Open-end accounts that are placed on a fixed repayment schedule are subject to this timeframe.

For operational purposes, charge-off should be taken no later than the end of the month in which the applicable period elapses. Any full payment received after the applicable period but before month-end charge-off may be considered in determining whether charge-off remains appropriate.

Loss timeframes specific to accounts of bankrupt or deceased customers are also articulated in the Retail Classification Policy:

- For loans in bankruptcy, the shorter of (i) the normal timeframes specified in the guidance or (ii) within 60 days of receipt of notification of filing from the bankruptcy court, unless the bank clearly demonstrates and documents that repayment on the account is likely to occur.
- For loans of deceased customers, the shorter of (i) the normal timeframes specified in the guidance or (ii) when the loss is determined.

Loss practices for fraudulent loans are discussed in the Fraud section of this chapter.

The Retail Classification Policy does not preclude the adoption of more stringent internal charge-off policies. Further, when a portfolio's history reflects high losses and low recoveries, accelerated charge-off timeframes are normally appropriate and necessary. Some banks have instated, at their own will or at the prompting of regulators, policies that accelerate charge-offs.

If a cardholder has more than one account with the bank and one of the accounts is charged-off, appropriate actions for the consumer's other accounts at the bank need to be determined. Depending on the situation, appropriate action might include charging-off or closing the account and/or increasing allowances.

At the time of charge-off, most credit card banks only charge a portion of the gross loss to the ALLL. Rather, they attempt to only charge the loan's principal balance to the ALLL. The remainder of the balance (fee and interest losses) is charged back directly against the income statement. This process of splitting principal losses from fee and interest losses is known as **purification**. The Allowances for Loan Losses chapter discusses principal losses versus fee and interest losses in more detail.

In lieu of charging-off the entire loan balance, loans with non-real estate collateral (for example, deposits) may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process. Guidelines for loans secured by real estate are detailed in the Retail Classification Policy. Business cards, such as travel and entertainment cards, are evaluated on a case-by-case basis. Under no circumstances should the formula approach be used to charge-off large business type loans serviced by the bank's installment department.

Examiners should review charge-off rates and volumes. They may consider the Lag Ratio, which is the ratio of net credit card losses for the last three quarters measured against total delinquent credit card receivables as of three quarters ago (delinquent loans include loans past due 30 to 89 days plus total non-current loans). The lag ratio provides an estimate of the percentage of delinquent loans which subsequently are charged off. Examiners should review system settings for charge-offs to verify that the parameters correspond to those described in the bank's policies and comply with the Retail Classification Policy. Examiners should also review cases where credit card loans have not charged-off at the shorter of the timeframes within the banks' policies or within the Retail Classification Policy. When reviewing the banks' charge-off data and reports, examiners should be careful to factor in any changes made in the bank's charge-off timing and practices that may be impacting charge-off volumes and should also understand how the bank's purification processes are impacting the reported volumes.

Post-Mortem

Once an account charges-off, the bank normally is still not done managing the account. The need and desire for post-mortem (or post-charge-off) portfolio grooming continues to grow. Customized models that can project potential cash flow from charged-off portfolios have been developed and help the bank determine the value of keeping or selling the accounts. In addition, post-mortem analysis can help to identify weak points in portfolio management that may have influenced the breakdown of the program or account. By identifying the weak points, management can then take appropriate action to ensure the weaknesses are corrected and to address any remaining risks from existing actions of the same or similar nature.

Recoveries:

As part of post-mortem practices, the bank manages recoveries. Recoveries represent the money (collected payments) received on an account after it is charged-off and can consist of principal, interest, and fees. The amount recovered is dependent on several factors, including policies for collections and charge-offs, systems for internal control, supervision over the collection department, experience of the collection staff, and collection efforts during the various delinquency stages. A high level of recoveries compared to charge-off volume may indicate a conservative charge off policy. Or, it may indicate inadequate collection efforts prior to charge-off, a poorly trained collection staff, or inadequate management supervision. A low level of recoveries compared to charge-off volume may indicate a lax charge off policy, inadequate collection efforts, a poorly trained collection staff, or inadequate management supervision.

Recovery efforts may be in-house or outsourced to collection agencies. In addition, charged-off accounts can be sold to third-party entities. Most often, banks maintain charged-off accounts in-house for several months before turning them over to collection agencies or selling the accounts. The collection agencies normally agree to collect the accounts based on a fee that depends on the degree of complexity of the collection. The basis for sales of charged-off accounts is usually a certain percentage of the dollar amount of the charged-off account.

Banks are expected to properly report recoveries, as set forth in many instructional materials including, but not limited to, the AMG, accounting guidance, and Call Report instructions. Usually some or all of the recoveries are reported as recoveries to the ALLL. However, if the amount that the bank credits to the ALLL is in excess of the amount previously charged against the ALLL for that loan (which may have been limited to principal), the bank's net charge-off experience will be understated. Rather, any recovery amounts collected in excess of the amount charged against the ALLL for a loan should be recognized as income. Also, the rebooking of charged-off assets is an improper practice.

Fraud

Fraud is a continuing problem for banks that engage in credit card activities. As a result, banks, the Networks, and other vendors have strengthened systems and controls to reduce fraudulent activities. Advances in fraud detection have resulted in fraud losses, measured as a percentage of total sales volume, decreasing over time for many banks. Entities can curb the amount of fraud losses by tracking fraudulent activities according to type and by designing control systems that detect fraudulent activities in a timely manner. Some activities banks have instituted to reduce fraud include:

- Improved application review, including verification procedures.
- Call-to-activate requirements for new cards and re-issued cards.
- Pattern recognition programs and systems.
- Increased level of payment review.
- Authorization improvements.
- Increased training of employees in fraud detection practices.

Many banks have dedicated fraud staffs that oversee the many activities required when potential fraud is identified. When a cardholder alleges fraudulent activity on their account, an investigation is undertaken and, if delinquent, the account's delinquency status is either rolled-back or frozen. If the investigation negates the fraud allegation, proper actions include returning the account to its previous delinquency status and immediately reinstating collection efforts. For accounts that do constitute fraud, the fraudulent loan should be charged-off within the shorter of (i) 90 days of discovery or (ii) the general delinquency timeframes specified in the Retail Classification Policy (and discussed in the Charge-off section of this chapter). The charge-off should be taken by the end of the month in which the applicable time period elapses. Fraud losses are reported as a miscellaneous expense and are not applied against the ALLL.

REPORTING AND TRACKING

Tracking and monitoring the credit card portfolio is one of the most critical risk management functions performed and is one of the best defenses against an economic downturn. The quality of accounts, reflected in credit scores or other indicators, is constantly changing through attrition, new solicitations, and/or demographic shifts. Delinquency and loss rates also change constantly because of fluctuation in consumer behavior patterns and changes in general economic conditions. If management is not aware of these changing conditions, it cannot quickly react to adverse trends and build upon past successes. Reports are prepared at various intervals (daily, weekly, monthly, quarterly), depending on the report's intended usage. In addition, the complexity and sophistication of reports varies depending on the size and complexity of the programs as well as of the bank itself.

Because credit card portfolios generally consist of a large number of relatively small-balance accounts (as compared to other types of loans), identifying the changing conditions and evaluating the quality of the credit card portfolio on a loan-by-loan basis is inefficient and burdensome. Rather, reporting and tracking of the portfolio and its various segments provides the most efficient method of identifying changes and evaluating portfolio dimensions, composition, and performance. Effective reporting and tracking promote early and accurate identification of existing or potential problems (operational or otherwise) and promptly identify needed policy and procedure revisions. Successful reporting and tracking informs and arms management with the tools to understand the risk characteristics of the portfolio, which can be quite varied in nature. Review of management reports should be undertaken during the on-site examination to ascertain the comprehensiveness and accuracy of the information provided therein. In the absence of sufficient reporting, examiners may need to request that management develop additional reports or the examiner may need to calculate certain data (such as utilization rates, average outstanding balance per account, delinquency ratio, charge off rates, or other items of interest) with whatever information may be available. If sufficient reporting is not evident, management should be appropriately criticized.

Many well-run companies have highly evolved analytics and reporting systems. Effective reports provide management with the tools to assess whether operations remain consistent with strategic objectives and within established risk, return, and credit performance tolerances. They also aid management in identifying developing trends, making strategic decisions, detecting potential problems, managing vendor relationships, and responding to changes in economic, industry, and regulatory environments.

Segmenting

To maximize the effectiveness of portfolio tracking, management uses segmentation, which was introduced in the Marketing and Acquisition chapter. The various sub-populations comprising the credit card portfolio may have vastly different performance patterns and levels of risk. These differences might be masked if receivables are only analyzed on a total portfolio basis.

Management can segment a portfolio many ways. The use of multiple approaches is common and encouraged. Each segmentation method provides different perspectives and insights. With more information, management is better able to analyze and understand their customers, pinpoint the cause of asset quality problems, eliminate unsuccessful strategies, and further refine successful strategies. Common segmentation methods include, but are not limited to:

- Product line.
- Geographic location.
- Vintage.
- Time-on-book.
- Marketing channel or acquisition method.
- Credit bureau score.
- Delinquency stage.
- Behavior or other risk score.
- Utilization rate or bands.
- Owned (on-book) portfolios, securitized portfolios, and other off-book portfolios (potentially such as portfolios associated with Rent-a-BIN programs).

Dollars and Units

Management reporting often includes insight both on a dollar basis and on a number of accounts (or unit) basis because trends might be more distinct or may arise earlier in one type of reporting as compared to the other.

Levels, Trends, and Performance

Effective reporting provides for an analysis of levels and trends to determine the bank's condition from a strictly analytical viewpoint. Concerns may arise if reports merely depict data and do not clearly evidence analysis of performance results and trends. For example, credit line increase reports should not only identify the number and volume of credit line increases granted but should also depict the performance of those accounts after they receive the line increase so that management can assess whether its line increase practices are effective.

Key Indices

Management reports should identify various key indices because such indices can be beneficial in determining the quality of the credit card portfolio. Key indices should generally be tracked for each portfolio segment to gauge performance within that segment or to the managed portfolio. Calculations of ratios can vary from bank to bank, and as such, the examiner will need to ensure that they understand each particular bank's reporting and measurement methods.

Projected Versus Actual Performance

Effective portfolio management clearly communicates portfolio objectives such as growth targets, utilization expectations, rate of return hurdles, and default and loss expectations. Management normally has a variety of reports that monitor actual performance as compared to projected performance for these types of objectives. For example, management may review variances between actual and projected performance of a certain portfolio to enhance or modify future marketing campaigns.

Peer Comparisons

Management often tracks performance and data on its peers. While this can be a valuable tool, peer data for comparative purposes may be distorted due to niche marketing, specialized card products, or extensive affiliate support. When using peer comparisons, consideration must be given to the ways the peers' programs are similar to the bank's programs as well as how the programs differ and how those differences may impact ratios and data reviewed.

Ownership and Clarifying Information

Although not required, the most effective reports identify the report's preparer (if not system generated) and include clarifying information, such as definitions of various items in the reports, when helpful. For example, the definition of active account can vary from bank to bank and even within a bank. The inclusion of such items helps to ensure that the reader is able to fully understand the report and accurately draw conclusions from the reported information.

Common reports

The following types of reports are common, although segmentation methods within the reports vary widely. The list is merely illustrative, not exhaustive.

Report Type	*Description and/or Common Contents*
Application Distribution Reports	These reports show the disposition of applications over time. The volume of applications received; approval, rejection, and override rates; and the distribution of scores are usually detailed.
Delinquency Distribution Reports	These reports show delinquency by credit bureau score over time. Consequently, they help validate the bank's scoring system by demonstrating whether delinquent accounts are rank-ordered by score. A decrease in the differentiation between scores and delinquency rates over time may indicate an erosion of the scoring system.
Chronology Logs	These reports detail significant events, both internal and external. Items recorded might include, but would not be limited to: major solicitation campaigns, change in cutoff scores or other underwriting criteria, economic recessions, policy changes, and regulatory changes. These logs can assist management in explaining changes in portfolio performance.
Over-Limit Reports	These reports usually detail the type, number, and dollar volume of over-limit accounts. They are often segmented into "over-limit and current" population and the "over-limit and delinquent" population. Performance of over-limit accounts is also tracked. Over-limit reports should correlate with delinquencies, charge-offs, and fraud losses to assist management in determining whether its over-limit parameters adequately control losses or need refinement. Tracking manual over-limit authorizations by credit analyst helps to ensure accountability and to assess the individual analyst's decision-making skills.
Utilization Reports	These reports depict utilization, usually by band or range (for example, in 10 percent increments). Since they extend beyond 100 percent utilization when needed, these reports sometimes overlap with over-limit reports. The reports can include a variety of data, including dollar volumes, units, and available credit. Purchase volumes and fee and interest assessment volumes may be split out. The reports also can track performance of accounts by utilization range.
Cure Program Reports	These reports depict volume (unit and balance), loss performance, and performance of the accounts at specified intervals after entering the cure programs. They are generally segmented by program and compare performance of those accounts in the particular cure program to those accounts in the general population.
Concentration Reports	These reports depict geographic, customer base, card type, or other types of concentrations and

	may include data such as the dollar volume, unit volume, and performance data (delinquency, payment rates, loss information, and so forth) for the accounts in the concentration population.
Re-aging Reports	These reports track re-aged accounts against total accounts and dollar amounts outstanding to evaluate the effect re-aging procedures have on overall delinquency and charge-off ratios. The reports also track performance of the re-aged population, usually by month, after the account has been re-aged and usually by type (manual or automated). Tracking manually re-aged accounts by credit analyst or approving officer and identifying the reason for re-age helps to establish accountability.
Credit Line Increase Reports	These reports usually identify the dollar volume and number of credit line increases as well as performance of the accounts after the increase. They might also depict average line increases.
Loss Reports	These reports usually measure the dollar volume and number of accounts charged-off. They often also include the average balance of charged-off accounts and recovery information. A break-out between principal and fees and interest is frequently included.
Roll-Rate Reports / Migration-to-Loss Reports	These reports identify the migration (or movement) of dollar balances and/or units through the delinquency stages and charge-off. These reports are discussed in detail in the Allowances for Loan Losses chapter.
General Collections Reports	These reports identify data on various collection department functions. For example, they might include productivity information (call penetration, right-party contacts, promises made, promises kept, dollars collected, and staffing summaries). They may also identify special handling queue information or a variety of other information.
Payment Reports	These reports generally depict payment volumes and numbers (usually by month), insufficient funds volumes and items, payment rates, and average payment size.
Exception and Override Reports	These reports identify instances where practices have been outside of established policy guidelines or where credit decisions are contrary to those suggested by the scoring system. Information included will vary depending upon what type of exception or override is being tracked.
Customer Service Reports	These reports identify various statistics for the customer service department. They might depict the volume of calls answered by automated systems, the volume of calls handled by customer service representatives, the average speed of answer, the average length of a customer service call, customer service mail

	volume handled, length of time to respond to mail inquiries, and so forth.
Ad Hoc or Special Study Reports	These reports are completed on a case-by-case basis when management wants or needs to know about something that is not normally tracked on a regular basis. For example, many banks developed such reports when the AMG was first issued (to determine the impact of the guidance) and when Hurricane Katrina occurred.
Other Types of Reports	There are many other reports, some of which cover fraud, settlements, and vendors. Examiners should ask for the main reports that management uses (such as reports contained in board packets and reports reviewed regularly by department managers).

SUMMARY OF EXAMINATION GOALS – PORTFOLIO MANAGEMENT

Overall goals when reviewing portfolio management are to assess the effectiveness of activities and strategies used to enhance performance and increase profitability of existing portfolios and to determine the implications of those activities and strategies have on the quality of the portfolio and the quantity and direction of risk within the portfolio. Furthermore, examiners should assess whether the bank's strategies comply with applicable regulatory guidance, such as the AMG and the Retail Classification Policy. A few summary concepts of examination guidance provided throughout the chapter include:

- Identify the departments or individuals responsible for portfolio management activities.
- Review policies, procedures, and analytical techniques for portfolio management to ensure they are comprehensive and thorough.
- Evaluate account management practices and the corresponding policies and procedures for adequacy, considering the individual bank's circumstances.
- Assess the tools, systems, and available MIS to ensure that management is provided with necessary and timely information.
- Determine whether management's segmentation strategies for the card portfolio and its analysis of the performance of the segments are sufficient. For example, do they allow management to effectively monitor credit card receivables, identify trends, and proactively address developing problems.
- Review segmentation criteria, and assess its usefulness for portfolio analysis, including adverse classifications (as outlined in the Adverse Classifications chapter).
- Assess systems and practices for authorizing transactions.
- Assess systems and practices for managing credit lines and determine whether the practices conform to regulatory requirements.
- Review over-limit policies and practices and determine whether the bank's management of over-limit accounts satisfies regulatory requirements.
- Determine fee assessment practices and fee waiver practices as well as the resulting impacts on the portfolio and earnings.
- Review minimum payment structures and the volume and trends of negative amortization within the portfolio(s), and determine whether the bank's practices in these areas satisfactorily address regulatory requirements.
- Review payment deferral and prepayment programs, and determine to what degree these programs impair management's ability to evaluate asset quality or significantly increase credit risk. Review management's process to establish these types of programs, and determine how management monitors the performance of and impacts from these types of programs.

- Evaluate the effectiveness of collection policy guidelines and procedures.
- Assess the organization and staffing of the collections function.
- Determine whether re-aging, workout, and/or other programs are used constructively or if they delay the recognition of delinquency and loss.
- Evaluate the bank's charge-off policies and practices. Determine if accelerated charge-off timeframes are warranted.
- Assess recovery practices and volumes on charged-off accounts.
- Evaluate fraud detection and prevention programs, consider the impact of fraud losses on earnings, and verify that such losses are promptly charged-off and properly reported.
- Assess the organization and staffing of the customer service function, and determine how management monitors the successfulness of services provided.
- Determine the extent that management relies on third-party vendors in the portfolio management process and how management monitors the third-party vendors.

The following items might signal current or future elevated risk and warrant follow-up:

- Very high or low recovery rates or significantly fluctuating recovery rates.
- High or increasing volumes of accounts/receivables in cure-type programs.
- High or increasing re-aging volumes.
- Changes in charge-off timeframe practices.
- High or increasing volumes of over-limit accounts/receivables, including those that are considered chronic.
- High volumes of credit line increases for the portfolio, or frequent credit line increases per account.
- Lack of sufficient segmentation strategies.
- Lack of sufficient management reports.
- High volumes of negative amortization, especially if prolonged.
- Lax authorization strategies.
- Unusual fee waiver activity or excessive fee assessment practices.
- High or increasing volume of consumer complaints, or consumer complaints of a significant nature (for example, accusation of unfair or deceptive practices).
- Lack of appropriate controls over third-party relationships.
- High or rising fraud volumes.

X. TRANSACTION TESTING

Transaction testing generally refers to the testing of individual loans and is also known as account testing, account sampling, or transaction-level testing. Transaction testing is generally performed as part of each full scope examination of a bank engaged in credit card lending and is sometimes incorporated into target examinations or visitations when helpful in analyzing the areas slated for review. According to the *Expanded Guidance for Evaluating Subprime Lending Programs,* transaction testing should be completed at each regularly-scheduled examination of banks engaged in subprime lending. Transaction testing is one of the best techniques to unearth the true quality of card portfolios and loan administration practices.

REASONS FOR CONDUCTING TRANSACTION TESTING

Transaction testing is used to determine whether:

- Individual loans adhere to policy, underwriting, risk selection, and pricing standards.
- Management, board, and regulatory reports are accurate and timely.
- Loan accounting and servicing meet appropriate standards, including those for account management.
- Key risk controls and control processes are adequate and functioning as intended. Some examinations have revealed that even when written policies and procedures appear satisfactory, system settings or other devices might be allowing activity that is contrary to the policies and/or that does not meet applicable guidance and laws.
- Roll-rates and other loss forecasting methods used to determine loss allowance levels are accurate and reliable.
- Lending practices exist that may appear unsafe, unsound, abusive, or unfair.

Its results may also aid examiners in determining adverse classifications. The findings of transaction-level testing are incorporated into examination conclusions regarding overall asset quality, the adequacy of loss allowances and capital levels, and the adequacy of risk management practices.

TESTING METHODS

The FDIC generally does not require the use of any specific sampling methodology in its safety and soundness examinations of banks engaged in credit card lending. Rather, the type and extent of sampling used is generally left to the discretion of the examiner-in-charge (EIC). The EIC's use of common sense and judgment are critical in determining the focus and extent of testing. To decide on the type of sampling to use, examiners consider the quantity, quality, and nature of the population to be reviewed; the bank's risk management systems; the bank's appetite for risk; the objectives and benefits of the different sampling methods; and the purpose and objective of the sample. Transaction testing is most often categorized into two methods: judgmental or statistical. A brief discussion of each of these methods follows.

Judgmental

The judgmental method is often used during examinations and provides for sampling without statistical measurement. With this method, examiners identify the bank's areas of greatest risk exposure and select items for review using sound judgment and knowledge of a bank's policies, controls, and systems. This method allows examiners to review an identified percentage (coverage) of a specific population. Although examiners cannot statistically relate the results to the entire population, they can identify specific exceptions.

Statistical

Statistical sampling can also be considered and is effective when testing portfolios of homogeneous accounts. Statistical methods are more complex than judgmental methods, but the benefit is the ability to quantify the results and state with a statistically valid confidence that the results are reliable. The complexity of the two types of statistical sampling (proportional and numerical) generally makes them fall outside the scope of this manual. However, brief comments on statistical methods are offered.

With proportional sampling, the population to be sampled is defined by dollar amount. Proportional sampling can be useful to evaluate the quality of a loan portfolio because of the effect larger dollar items can have on asset quality.

Numerical sampling is appropriate for cases in which the frequency of errors, exceptions, or other feature of interest is of primary concern and the dollar amount of the exception is not considered relevant. The sample population is defined by the number of items and is mainly used to reveal the presence (or absence) of a defined characteristic in a portfolio of items with similar characteristics. Each population account has the same probability of selection as any other.

SAMPLING CONCEPTS

Key attributes of each sampling concept are discussed in the next sections and mainly focus on judgmental sampling. But, both judgmental and statistical methods entail the same concepts:

- Population selection.
- Sample design and selection.
- Sample review.
- Evaluation and interpretation of results.

Population Selection

Populations are usually gathered via data queries that may be requested during the pre-examination process. Additional population queries are sometimes asked for during the examination when areas of concern are identified (possibly through policy review or other mechanisms) that are not already queried or if prior queries need refinement.

When selecting the populations for review, examiners should consider that querying a broad category (for example, all delinquent loans) can result in a very large population and in a query that may be difficult to work with and/or that may be ineffective to serve the testing objective. When possible, examiners should fine-tune query requests to retrieve only a segment or segments of a large portfolio, where the segment(s) would be reflective of the features of interest. Some examples of how to potentially sample for specific objectives are provided in this table:

Objective	*Possible Population Selection*
Test for compliance with underwriting practices, pricing, and terms.	New accounts booked since a particular date or during a recent month.
Test for appropriateness of credit score overrides, including reason for override.	New accounts that scored below a cutoff but were approved in the recent past (for example, during a month).
Test for appropriate use of re-aging.	Accounts re-aged during a recent period.
Test for appropriate charge-off practices.	Accounts ever 180 or more contractual days delinquent since a specific date but not charged-off.

Examples of some common populations are housed in the sample pre-examination request list in Appendix A. The list is for example purposes only and should be customized to reflect queries that are risk-focused for the particular circumstances of the examination. For example, if the prior examination identified concerns about certain practices, examiners would likely want to include queries designed to test whether or not management has addressed those concerns.

Sample Design and Selection

The size and composition of the sample drawn from the population should be commensurate with the risk characteristics of the population being tested. The size of sample group should also be sufficient to reach a supportable conclusion and should not be out of proportion to the overall population size that the sample is being drawn from.

In general, accounts should be randomly selected from each data query. Examiners sometimes conduct data sorts to get a feel for the content of the query (such as range of receivable balances, whether any duplicate accounts are included, and so forth). The data sorts help to make sure that the results of the query appear consistent with the query selection criteria and to make sure that there does not appear to be a mistake with the bank's query process. When conducting these data sorts, certain accounts of potential concern may become evident. While examiners should not ignore accounts of potential concern, they should not skew their sample towards these accounts either. Rather, in addition to pulling in some of potentially concerning accounts, examiners should ensure that a random sample of the remaining population is also selected. The random sample may be developed by extracting every n^{th} account (for example, every 20^{th} account in the data file) or some other method of the examiner's choosing.

Attempts by management to substantially influence or control the sampling selection process should be brought to the EIC's attention, and management should generally not select the sample. However, examiners should consider management's internal transaction testing practices when determining the size of the sample for the examination. For example, if management conducts timely, comprehensive and thorough transaction testing as part of its audit procedures and the bank is generally well-run, examination sample sizes may be reduced absent any other influential factors (such as rapid growth, soaring delinquency rates, and so forth). However, the sample size must still remain sufficient to support conclusions drawn.

Sample Review

After the sample is identified, examiners begin review of the accounts in the sample. Many banks provide examiners with controlled (such as read-only) access to terminals. With terminal access, examiners are granted password access and review the account's informational screens. It may be necessary to review consecutive months of activity on an account to see how certain transactions impact the account. Generally, the computer has printer access such that the examiner is able to print documents when necessary to support examination findings.

Whether the review utilizes hard copy or electronic information, examiners must be familiar with descriptions of transaction codes, internal and external status codes, reason codes, and other system settings that may assist them in efficiently and effectively reviewing the accounts. Lists of such items are usually requested during the pre-examination process.

While the objective of a sample is to review accounts for a specific characteristic (or feature of interest), examiners should remain alert for any other unusual activity or characteristics in regards to the account. Examiners should also be alert for potential discriminatory, unfair, deceptive, abusive, or predatory lending practices.

Evaluation and Interpretation of Results

If exceptions are absent, no further evaluation is required. Rather, examination workpapers should be prepared to state that no exceptions were identified in the sampled pool. But, when exceptions are found, examiners should further analyze and evaluate the exceptions in an attempt to determine the root causes of the exceptions and whether the exceptions are isolated occurrences or a pattern or practice. Some possibilities to explain an exception could be:

- Bank personnel's inexperience, lack of training, or inadequate policy knowledge.
- An intentional disregard for policies, procedures, laws or other guidance.
- Improper system settings.

However, many other explanations may exist. If a tested sample reveals numerous exceptions, the sample should be expanded until the actual quality of the population can be reasonably estimated. Results from judgmental sampling cannot be projected beyond the accounts sampled. However, exceptions may suggest a larger problem and should be considered when evaluating the quality of the population from which the sample was drawn.

SUMMARY OF EXAMINATION GOALS – TRANSACTION TESTING

Account-level testing is intended to help gauge whether management adheres to policies as well as regulatory and other guidance; whether its risk management practices are acceptable; and whether there are any factors influencing asset quality that are not readily apparent during portfolio-level review. When the bank's profile reflects elevated risk (such as subprime lending), an increase in delinquency or loss rates, new lines of business, new acquisition channels, rapid growth, or inadequate internal testing or audits, account-level testing becomes an even more important and integral part of the examination process. For account testing to be effective, examiners must carefully determine the populations to be sampled, prudently select the accounts to be sampled from those populations, thoroughly review the chosen accounts, and ensure that conclusions are well-thought out and fully-supported. Examiners then incorporate the findings into the examination conclusions regarding overall asset quality, the adequacy of loss allowances and capital levels, and the adequacy of risk management practices.

XI. ADVERSE CLASSIFICATIONS

To quantify and communicate the results of the card portfolio and lending appraisals, the examiner decides which credit card related assets will be subject to criticism and/or comment in the examination report. Based on the volume of accounts in the portfolio and on the relative small size of the loans on an individual basis, credit card loans are classified using methods that are different than those normally used for traditional types of credit, such as commercial loans or agricultural loans. But, similar to other types of credit, adversely classified credit card assets are allocated by risk to three categories: Substandard, Doubtful, and Loss.

The three adverse classification categories are expressions of different degrees of a common factor, risk of nonpayment. All credit card loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound credit card loans. The practice of appropriately lending to financially sound businesses or individuals for reasonable periods via credit card loans is a legitimate banking function. As such, adverse classifications of credit card loans should be confined to those loans which unduly put the investment of depositors' funds at risk. To determine which credit card loans fit this description, examiners must consider guidelines within the Retail Classification Policy. That guidance governs the evaluation of small-denomination consumer loans, which include credit card loans. In addition to establishing general classification thresholds based on delinquency, the Retail Classification Policy grants examiners the discretion to classify individual loans as well as portfolios or portfolio segments that exhibit signs of credit weakness regardless of delinquency status.

DELINQUENCY THRESHOLDS

Repayment performance of individual borrowers traditionally is the best indicator of credit card loan quality. Therefore, credit card loans, at a minimum, are generally classified based on the following criteria from the Retail Classification Policy:

- Open-end and closed-end credit card loans that are past due 90 or more cumulative days from the contractual due date are classified Substandard.
- Closed-end credit card loans that become past due 120 cumulative days and open-end credit loans that become past due 180 cumulative days from the contractual due date are classified Loss and charged-off.

The Charge-Offs section of the Portfolio Management chapter discusses losses and includes the Retail Classification Policy’s criteria for charging-off accounts such as those for bankrupt or deceased cardholders. Its fraud section talks about fraudulent accounts.

According to the January 31, 2001 *Expanded Guidance for Evaluating Subprime Lending Programs*, subprime lenders should recognize the heightened loss characteristics in their portfolios and should, therefore, internally classify delinquent accounts well before the timeframes specified in the Retail Classification Policy. Additional considerations for subprime loans, including those that are collateral dependent, are discussed later in this chapter.

If a bank can clearly document that a past due credit card loan is well-secured and in the process of collection, such that collection will occur regardless of delinquency status, then, according to the Retail Classification Policy, the credit card loan generally does not need to be adversely classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property that has an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

EXAMINER DISCRETION

While the Retail Classification Policy provides minimum guidelines for adverse classifications based on delinquency thresholds, it does not preclude examiners from classifying credit card loans that exhibit other signs of credit weakness. Thus, examiners may also consider adversely classifying certain current loans and certain other delinquent loans. An examiner may classify credit card portfolios, or segments thereof, where underwriting standards, risk management practices, account management practices, or other controls are weak and present an excessive level of credit risk. Regardless of the classification methodology used, examiners must adequately assess and document the risk supporting the classifications.

Proper determination of adverse classifications requires examiners to acquire certain fundamental information about the credit card portfolios, borrowers' financial conditions, prospects for orderly debt repayment, and available collateral. Acquiring the information varies with the size of the bank and the portfolio types as well as with the type and sophistication of available records and reports.

Usually the examiner discretion method involves portfolio analysis. Common predictive indicators reviewed as part of portfolio analysis and that sometimes result in adverse classifications include, but are not limited to, over-limit loans, delinquencies, and score distributions.

- *Over-limit loans* – Loans that are over-limit, whether current or delinquent, may be, but are not necessarily, subject to adverse classification. Because over-limit practices vary from bank to bank and because the types of credit card programs vary from bank to bank, comparison of over-limit ratios from bank to bank is generally not the determining factor in assigning adverse classifications. Rather, a more fitting method of evaluating over-limit accounts for adverse classification lies in determining the trend and characteristics of over-limit accounts within the bank under review. Consideration is given to the make-up and reasons for the volume of over-limit credit card receivables/accounts as well as trends in performance of the over-limit receivables/accounts. For example, if all or a certain segment of over-limit loans (for example, chronic over-limit loans) are shown to typically move to charge-off, adverse classification should be considered.
- *Delinquencies* - Loans overdue, but overdue to a lesser degree than the specified delinquency thresholds, may be, but are not necessarily, subject to adverse classification. Examiners should review the delinquency trends in certain higher-risk portfolios or categories of loans to determine if those pools warrant adverse classification, even if delinquency is below the specified thresholds, keeping in mind any distortion resulting from seasonal influences, economic conditions, or the timing of examinations and keeping in mind the type of program that the bank offers. Examiners should carefully consider the makeup and reasons for the volume of overdue credit card loans. For example, subprime portfolios typically reflect higher delinquency levels than prime portfolios, but that in and off itself may not be reason to adversely classify a subprime portfolio. If migration analysis reflects that substantially all of a certain segment of loans eventually flows to charge-off (regardless of whether the overall volume of delinquencies is of concern), it may be appropriate to classify that segment of loans. Some loans that evidence frequent delinquency histories within a recent period but that may now be current can also be considered for adverse classification in certain situations.

- *Scores* – Pools of loans within certain score ranges may be, but are not necessarily, subject to adverse classification. Select pools of receivables sometimes reflect increased (and undue) risk based on the cardholder credit scores, behavior scores, or other types of scores. For example, as part of management's segmentation methods, a report might show that accounts of cardholders within certain credit score ranges might evidence a much higher propensity to roll to loss than the remainder of the portfolio. Those accounts could be considered for adverse classification if the propensity is regarded as substantial enough to warrant adverse classification.

These factors (over-limit accounts, delinquencies, and score distributions) are just a few examples of the types of characteristics that could lead to adverse classification of the associated loan pools when circumstances warrant. Common sense and judgment are critical in determining the extent of adverse classifications, and management's segmentation reports are often a good starting point to identify any segments that might be evidencing higher risk and, therefore, may need to be considered for adverse classification.

In addition to portfolio analysis, the account-level reviews conducted during the examination (as discussed in the Transaction Testing chapter) may aid the examiner in assigning adverse classifications. The reviews may reveal concerns which could lead to certain portfolios, or segments thereof, being adversely classified. For example, if the account-level review shows that the bank has been improperly moving accounts from one workout program to another to delay losses, the pool of workout accounts, or a certain segment thereof, may warrant adverse classification, even if the loans do not meet the specified delinquency thresholds.

Subprime Loans:

Adverse classification considerations are extremely critical for subprime lending programs, and examiner discretion is most often the preferred method of determining classifications for these types of high-risk portfolios. While subprime loans fall under the umbrella of the Retail Classification Policy, standards within that policy are considered minimums, and expanded or more severe classifications for the subprime portfolio may be warranted.

The *Expanded Guidance for Evaluating Subprime Lending Programs* specifically addresses classification guidelines for subprime lending. Examiners should not automatically adversely classify or special-mention credit card loans merely because they are considered subprime. Subprime credit card loans that are past due 90 days or more should be classified at least Substandard based on a reasonable presumption that the past due status is indicative of inadequate capacity and/or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience, or other risk indicators, of the particular portfolio or segment thereof. When portfolio review or transaction testing indicates serious concerns with credit risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire subprime portfolio or segments thereof. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems.

Mutually Exclusive Figures:

When determining adverse classifications, examiners must be careful to ensure that the volumes used for classification purposes are based on mutually exclusive figures so as to avoid double-counting. For example, if it is determined that all chronic over-limit balances should be adversely classified, examiners should be careful to only include those chronic over-limit balances that have not already been included in another adversely classified pool of receivables (for example, in a delinquency threshold pool). The process of whittling down the portfolio into mutually exclusive figures is necessary to accurately reflect risk in the card portfolio.

SPECIAL MENTION

A Special Mention asset has potential weaknesses that deserve management's close attention and that, if left uncorrected, might result in deterioration of the repayment prospects for the asset or in the bank's credit position at some future date. The nature of this category precludes inclusion of smaller lines of credit, such as credit card loans, unless those loans are part of a large grouping listed for related reasons. Special Mention assets are not adversely classified and do not expose a bank to a high enough level of risk to warrant adverse classification. Nevertheless, careful identification of loans (or portfolios) that properly belong in this category is important in determining the extent of risk in the aggregate loan population and providing constructive criticism to management. While Special Mention Assets should not be combined with adversely classified assets, their total should be considered in the analysis of asset quality and management, as appropriate.

SUMMARY OF EXAMINATION GOALS – ADVERSE CLASSIFICATIONS

To quantify and communicate the results of the card portfolio and lending appraisals, the examiner decides which credit card related assets will be subject to criticism and/or comment in the examination report. When deciding which credit card loans will be subject to criticism and/or comment in the examination report, examiners use the Retail Classification Policy and examiner discretion. Assigning adverse classifications usually involves:

- Reviewing past due reports to identify loans subject to adverse classification based on the delinquency thresholds in the Retail Classification Policy.
- Reviewing management’s internal classification methodologies (which may include a review of allowance methodologies to see what accounts, portfolios, or portfolio segments management considers as high-risk).
- Reviewing classification methodologies used in prior examinations and determining whether they remain appropriate or require adjustment. This may include assessing policy and procedure changes made since the last examination.
- Reviewing management reports, including those available on a segmented basis, to identify portfolios or portfolio segments that may warrant adverse classification.
- Reviewing results of transaction testing to identify any loan pools that warrant adverse classification.
- Developing classification volumes (ensuring use of mutually exclusive figures) and write-ups.
- Discussing the classification methods used with the EIC and providing documentation thereof to the EIC.
- Discussing classifications with management.

XII. ALLOWANCES FOR LOAN LOSSES

An assessment of the appropriateness of allowances for credit card loan losses is critical to the safety and soundness of banks and to the protection of deposit insurance funds. Allowance levels must be sufficient to absorb estimated credit losses[7] within the credit card portfolio. The term estimated credit losses means an estimate of the current amount of loans that it is probable the bank will be unable to collect; that is, net charge-offs that are likely to be realized for a loan or group of loans given facts and circumstances as of the evaluation date. Examiners are responsible for determining whether management has prudent controls in place to consistently determine the adequacy of the allowance in accordance with generally accepted accounting principles (GAAP), the bank's internal policies and procedures, and relevant regulatory guidance.

Examinations have revealed allowance methodologies that failed to adequately identify and provide for all uncollectible loans within the card portfolio. The deficiency has usually related to the level of estimated credit losses in loans that are current and in the portion of credit card balances comprised of fee and interest charges. Many credit card allowance methodologies inappropriately only focused on estimating credit losses in delinquent accounts instead of estimating credit losses in the entire portfolio. Other concerns have centered on over-reliance on historical loss rates without sufficient adjustment for current conditions and on unallocated allowances to offset weak allowance practices.

Methods to evaluate credit card allowances vary and are influenced by factors such as the bank's size, organizational structure, business environment and strategies, management style, card portfolio characteristics, administration procedures, and MIS. But, examiners should expect that all credit card reserving methods have certain common characteristics. They should be accurate, credible, adaptable, executable, and supportable, and should generally include:

- Detailed portfolio analyses, performed on a regular basis.
- Consideration of all loans, whether current or delinquent.
- For loans not reviewed on an individual basis, segmentation of the portfolio into groups of loans with similar risk characteristics for evaluation under FAS 5, *Accounting for Contingencies*.
- Consideration of all known relevant (internal/external) factors affecting collectibility.
- Consistent application but, when appropriate, modification for new collectibility factors.
- Consideration of the particular risks inherent in different kinds of card products.
- Consideration of collateral values (less costs to sell), where applicable.
- A requirement that analyses, estimates, reviews and other methodology functions are to be performed by competent and well-trained personnel.
- The use of current and reliable data.
- Written documentation with clear explanations of supporting analyses and rationale.
- Consolidation of the loss estimates via a systematic and logical method that ensures allowance balances are recorded in accordance with GAAP.
- Validation on a regular basis.

[7] Estimated credit losses should include accrued interest and other fees that have been added to the loan balances (and are not already reversed or charged-off) and that, as a result, are reported as part of the bank's loans on the balance sheet. A bank may include these types of estimated losses in either the ALLL or a separate valuation allowance, which would be netted against the aggregated loan balance for regulatory reporting purposes. When accrued interest and other fees are not added to the loan balances and are not reported as part of loans on the balance sheet, the collectibility of these accrued amounts should nevertheless be evaluated to assure that the bank's income is not overstated.

While the underlying objective is similar to assessing allowances in a commercial bank, the credit card industry has adopted very specialized techniques. And, in some cases, management and its external auditors have adopted interpretations of GAAP that might warrant close inspection. Furthermore, amounts provided for estimated credit card losses might include multiple components, including the Allowance for Loan and Leases Losses (ALLL), separate valuation allowances for uncollectible credit card fees and finance charges, and/or contra-asset accounts.

Examiners need to be familiar with these issues to determine whether allowance methodologies are appropriate and whether the resulting allowance levels are adequate to cover estimated credit losses in the entire card portfolio. The processes, methodologies, and underlying assumptions for allowances require a substantial degree of judgment. Because of the imperfect nature of most estimates of inherent loss and the fact that no specific method is appropriate for all situations or all banks, examiners ascertain whether management makes reasonable estimates based upon careful analysis of the credit card portfolio, ensures those estimates are established using sufficient and accurate data, and adjusts estimates based on current economic conditions and other relevant factors.

Marketing and underwriting strategies, as well as economic conditions, can substantially affect allowance adequacy because those factors give rise to unique performance patterns. As a result, examiners should look for evidence that management segments the card portfolio into as many components as is practical and meaningful to arrive at accurate allowance estimates. They should also determine whether management reviews allowance levels for adequacy at least quarterly (and more frequently when warranted) and maintains reasonable records to support its evaluations. Allowances established in accordance with appropriate guidelines should fall within a range of acceptable estimates. When allowances are deemed inadequate, examiners require management to increase current period provision expenses, or re-state past provision expenses, to restore reported allowances to an adequate level.

This chapter reviews key concepts for evaluating allowance adequacy, including accounting and regulatory guidance, policy expectations, common methodologies, considerations that should accompany a methodology, and validation expectations. It also discusses allowances for interest and fees, unallocated allowances, and allowances for unfunded loan commitments.

ACCOUNTING GUIDANCE

For financial reporting purposes, including regulatory reporting, allowances and associated provision expenses for credit card loan losses are to be determined in accordance GAAP. GAAP does not permit the establishment of allowances that are not supported by appropriate analysis. Rather, it requires allowances to be well documented, with clear explanations of the supporting analysis and rationale.

Large groups of small-balance homogenous loans collectively evaluated for impairment, such as credit card loans, are not included in the scope of Financial Accounting Standards Board (FASB) Statement of Financial of Financial Accounting Standards (FAS) 114, *Accounting by Creditors for Impairment of a Loan.* Examiners should refer to FAS 114 for guidance in establishing allowances for credits that are reviewed individually and determined to be impaired (known as the line-by-line approach). FAS 5, however, is the main authoritative source for the accounting framework for reserving for credit card portfolios. FAS 5 provides the basic guidance for recognition of a **loss contingency** when it is probable that a loss has been incurred and the amount can be reasonably estimated (per paragraph 8 of FAS 5). FAS 5 does not permit accrual for loss events that are likely to occur in the future (have not yet occurred). Rather, the loss event must already have occurred as of the financial statement date (but the fact that the loss event has occurred might not yet be known).

Within FAS 5, paragraphs 22 and 23 address the collectibility of receivables, including credit card loans. According to those paragraphs, the conditions of paragraph 8 should be considered in relation to individual loans, or in relation to groups of similar loans, and accrual shall be made even though the particular receivables in which a credit loss has been incurred are not identifiable. Examiners should refer to the FAS 5 pronouncement for complete details. A variety of other implementing guidance is also available for review (bulletins, guides, and so forth). Examiners should assess management's application of FAS 5 in determining allowance adequacy for estimated credit card losses (for loans that are not reviewed individually for impairment and for loans reviewed individually that are not deemed to be impaired) and should determine whether management takes the risk of **unexpected losses** into consideration in assessing capital adequacy.

It is usually difficult to identify any single event that made a particular loan uncollectible. But, the concept in GAAP is that impairment of receivables should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and on conditions existing at the financial statement date. Delinquency status is not the only loss event. There are a variety of other loss indicators, such as, but not limited to, over-limit status, previous delinquency, re-aging history, insufficient funds history, and weak credit or behavior scores, which may be considered. In the case of a creditor that has no or limited experience of its own, reference to the experience of other entities in the same business may be appropriate.

The American Institute of Certified Public Accountants (AICPA) continues to work on a proposed Statement of Position (SOP) entitled Accounting for Credit Losses. The original proposal (2003) has been scaled back significantly and now focuses only on enhancing disclosures about credit quality and allowances. The AICPA is currently considering proposing that banks and other creditors would have to disclose provision expenses by loan type, type of borrower, geographic location, and so forth. Examiners must remain abreast of any forthcoming accounting guidance related to allowances for loan losses.

REGULATORY GUIDANCE

Additional guidelines for reserving reside in several regulatory documents, including:

- *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (December 1993) (FIL-89-93) (Interagency ALLL Policy).
- *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (July 2001) (FIL-63-2001). This policy statement is designed to supplement the 1993 policy statement.
- Call Report Instructions.
- Risk Management Manual of Examination Policies.
- *Interagency Expanded Guidance for Subprime Lending Programs* (January 2001).
- *Account Management and Loss Allowance Guidance for Credit Card Lending* (AMG) (January 2003).

The Interagency ALLL Policy requires that banks maintain an allowance at a level that is adequate to absorb estimated credit losses. It references FAS 5 and provides additional guidance. For pools of loans that are not individually reviewed and are not adversely classified, banks are generally required to carry allowances equivalent to the amount of estimated net credit losses over the upcoming 12 months. However, it footnotes that a charge-off horizon less than that may be appropriate for loan pools that are not subject to greater than normal credit risk, but only if the bank has conservative charge-off policies and if the portfolio has highly predictable cash flows and loss rates. Examiners are expected to review management's documentation on how the bank meets the exception requirement if it is maintaining allowances equivalent to a horizon less than 12 months.

Regulatory guidelines state that adequate allowances should be established for all loans (even if they are performing) and are consistent with FAS 5 requirements in that allowances must be established for groups of loans, even if the uncollectible loans are not individually identifiable at the current time. Regulatory guidelines also require additional allowances for potential volatility in loss rates, for imprecision that is inherent in any estimate of losses, for potential losses in loan commitments, and for possible increases in loss rates in the future. Unallocated allowances and allowances for unfunded loan commitments are discussed later in this chapter.

The *Expanded Guidance for Evaluating Subprime Lending Programs* requires examiners to perform specific evaluations of the allowances for subprime lending programs. It notes that the sophistication of management’s analysis should be commensurate with the size, concentration level, and relative risk of the bank’s subprime lending activities. It reiterates that the level of the allowance should cover estimated losses in accordance with both existing regulatory guidance as well as with GAAP. Further, it clarifies that, for pools of loans that are not adversely classified, the allowance should be sufficient to absorb at least all estimated losses over the current operating cycle (typically 12 months) and should consider historical loss experience, ratio analysis, peer group analysis, and other quantitative analysis.

The AMG requires banks to ensure that loan impairment analysis and allowance methods consider the loss inherent in both delinquent and non-delinquent loans. It also requires that banks ensure the allowance methodology addresses the incremental losses that may be inherent in over-limit accounts. If borrowers are required to pay a minimum payment that includes over-limit and other fees each month, roll-rates and estimated losses may be higher than indicated in the overall portfolio migration analysis (if that analysis is based on a less stringent minimum payment amount). The AMG also requires that management establish and maintain adequate allowances for each workout program. Management is expected to segregate workout program accounts to facilitate performance measurement, impairment analysis, and monitoring. In the case of multiple workout programs, each program should be tracked separately.

Examiners should refer to the actual documents for complete guidance as only brief overviews are offered in this manual. Overall, regulatory guidance is consistent with GAAP when requiring allowances sufficient to cover estimated credit losses in every segment of the credit card portfolio. Allowances should be established both for credit card loans that have an identified loss event, such as delinquency, and also for credit card loans that have other loss events that have occurred but that are not yet known to the bank.

Despite this consistency, certain situations may arise where differences in professional judgment will exist between regulators and the bank and its external auditors. But, estimates by each of these persons should generally fall into what is considered an acceptable range. When differences exist, examiners are encouraged, with the acknowledgement of management, to communicate with a bank's external auditors about rationale and findings. In case of controversy, FASB's Emerging Issues Task Force (EITF) Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and Regulatory Accounting Principals (RAP)*, may be referenced. The EITF addresses situations where regulators mandate that banks establish allowances under RAP that may be in excess of amounts recorded by the bank in preparing its financial statement under GAAP. Its consensus is that banks can record different allowances under GAAP and RAP but that auditors should be particularly skeptical in the case of GAAP/RAP differences and must justify those differences based on the particular facts and circumstances.

COMPARISON TO BUDGETED LOSSES

When using the FAS 5 approach, banks may not include losses expected to be incurred that result from post-financial-statement date events including new accounts originated, new charges made to existing accounts, and build-up of fee and finance charges on existing accounts. During the (assumed) 12-month horizon, a portion of these new accounts, new charges, and fee build-up will flow to loss, but these losses represent amounts that were not a part of the portfolio balance as of the financial statement date for which allowance adequacy was assessed. However, a bank's total budgeted losses for the 12-month time horizon would include all losses regardless of whether the amount is included in existing balances as of the financial statement date or result from post-financial-statement date events. Thus, a bank often incurs higher losses during a given 12-month period than it has provided for in the allowance as estimated credit losses at the beginning of that horizon. Examiners should review differences between the allowance and budgeted losses for reasonableness, including discussing the variances with management.

EXPECTATIONS FOR WRITTEN ALLOWANCE POLICIES

Banks use a wide range of policies, procedures, and control systems in allowance processes. Examiners are to determine whether written policies and procedures for the systems and controls for allowances are designed to ensure the bank maintains an appropriate allowance and are appropriately tailored to the size and complexity of the bank and its credit card loan portfolios. They should look for evidence that policies depict, in general:

- The roles and responsibilities of departments and personnel who determine or review allowances to be reported in financial statements.
- Accounting policies and practices, including those for charge-offs, recoveries, and collateral valuation.
- The description of the methodology, including what segmentation is used and how the methodology is consistent with accounting policies.
- The system of internal controls used to ensure that the allowance process is maintained in accordance with GAAP and supervisory guidance.
- Validation responsibilities and procedures.

METHODOLOGIES

An allowance methodology is a system that a bank designs and implements to reasonably identify estimated credit losses as of the financial statement date. Similar to traditional commercial banks, banks with credit card portfolios typically incorporate segmentation to determine needed allowances. However, the segmentation for credit card portfolios generally is not related to classifications or internal loan grades. Instead, delinquency status is usually the primary segmentation tool, although some banks use behavior scores, credit scores, or other segmentation techniques. Banks commonly use one or more of the following methodologies:

Roll-Rate Models

The roll-rate methodology predicts losses based on delinquency. While readily adaptable to credit card operations, most roll-rate methodologies assume that delinquency is the only loss event and that significant allowances are not needed until a loan becomes delinquent. Roll-rate methodologies are also known as migration analysis or flow models.

There is not a standard roll-rate model that is used throughout the industry, but most of these types of models are based upon the same principles. The credit card portfolio is segregated into delinquency buckets. Once segregated, the percentages of receivables that migrate to more severe delinquency buckets are measured, usually each month, and are referred to as roll-rates. Management considers roll-rates for the current month, current quarter, or an average of several months or quarters. Normally, it uses averages as a smoothing technique. Management may also track portfolio performance for several months to arrive at a weighted average distribution in each delinquency bucket. The time period used to arrive at this weighted average distribution should be long enough to have a smoothing effect on the loss seasoning curve.

Once roll-rates are determined, they can be applied to outstanding receivables within each bucket. The resulting balances are rolled through the delinquency stages based on the roll-rate for each stage and the end results are aggregated to arrive at the required allowance level. In some cases, loss factors (also known as roll-to-loss rates) are calculated by multiplying the roll-rates from each delinquency bucket forward through loss. The resulting loss factors are applied to the existing receivables in the applicable delinquency bucket and the end results are aggregated to arrive at the required allowance level. Exhibit A illustrates roll-rate and loss-factor concepts in an abbreviated, non-averaged fashion.

Exhibit A

Month	Current Balance	30 Days	Current-to-30 Roll-Rate	60 Days	30-to-60 Roll-Rate	90 Days	60-to-90 Roll-Rate	Current-to-Loss Factor
Oct.	$1,000	$39		$12		$ 9		
Nov.	$1,100	$40	4.0 %	$15	38.5 %	$10	83.3 %	1.28%
Dec.	$1,250	$50	4.6 %	$20	50.0 %	$12	80.0 %	1.84%
Jan.	$1,200	$65	5.2 %	$28	56.0 %	$17	85.0 %	2.48%

In Exhibit A, the 4.0 percent roll-rate for the current-to-30-day roll in November is calculated by dividing the 30-days delinquent balance for November ($40) by the current balance of the prior month ($1,000 in October). To calculate the 38.5 percent 30-to-60-day roll in November, the $15 balance that is 60 days delinquent in November is divided by the $39 balance that was 30 days delinquent in October. The 1.28 percent current-to-loss factor for November was figured by multiplying the roll-rates through charge-off (which for purposes of this example is assumed to be 90 days), or 4.0 percent x 38.5 percent x 83.3 percent. The example current-to-loss factors in Exhibit A are calculated moving straight across the table due to the limited table space available coupled with the aspiration to provide more than one example. Most often, though, roll-to-loss factors are calculated on the diagonal (for example, 4.0 percent X 50.0 percent x 85.0 percent).

The roll-rates assume that is the percentage of receivables that rolled from one bucket one month into the next bucket the following month. In reality, a delinquency bucket can contain:

- Accounts that rolled forward from an earlier-stage bucket in the prior month.
- Accounts that were in the same bucket last month (they may have paid but not enough to roll-back). These are sometimes called pay-and-stay accounts.
- Accounts that rolled back from a later-stage bucket because of payment or other considerations.

While the last two points may seem contradictory to the flow-to-loss concept that is being tracked, all accounts must be captured in the analysis. Again, examiners are reminded of the imprecision inherent in all loss predicting models. Over time and despite these apparent anomalies that may exist, the roll-rate method has proven fairly effective in estimating losses in delinquent accounts.

However, the method is less effective at providing an estimation of loss exposure in the loans that are not delinquent (which in most cases represents a majority of total loans) unless management includes some other approach for estimating losses in the performing segment of

the portfolio. As depicted in Exhibit B (on the following page), a simple, un-augmented roll-rate methodology generally derives an allowance balance that may cover a horizon of only six or seven months (one month for each delinquency bucket) with nominal coverage for current loans.
Exhibit B

Delinquency Status	*Allocation*	*When Loss is Recognized*
180 +	100%	Immediately
150-179	Derived from roll-rates	Next month
120-149	Derived from roll-rates	Month 2
90-119	Derived from roll-rates	Month 3
60 – 89	Derived from roll-rates	Month 4
30 – 59	Derived from roll-rates	Month 5
1 – 29	Derived from roll-rates	Month 6
Current	Must be determined	Month 7 and beyond

One reason that roll-rate models are less predictive for current accounts is that it is very difficult to estimate the balance of current accounts over the 12 month horizon, particularly when considering FAS 5 and trying to avoid the inclusion of new accounts and new charges. The balance of the current bucket often increases on historical roll-rate reports (even though some accounts are rolling out of it and into delinquency) because of:

- The origination of new accounts or new purchase and cash advance activity.
- The roll-back of accounts from delinquency into a current status due to payment on the account.
- The roll-back of accounts from delinquency into a current status due to other considerations, such as re-aging. Re-aging affects the normal migration of accounts, so verification that the volume of re-aged accounts does not materially affect the delinquency rate, normal charge-off rates, and accordingly the adequacy of allowances, is in order.

In addition, the predictive ability of roll-rates declines in the later months of the horizon because there is a lag in accounting for underlying changes in portfolio quality, especially in the relatively large current bucket. As such, when these changes cause portfolio quality to worsen, the roll-rate analysis might end up underestimating credit losses.

To address these concerns, there are a variety of ways that management analyzes the collectibility of performing loans. Some consider factors such as over-limit status, recent re-age history, workout status, utilization (usually stratified into buckets or ranges), the presence of certain status codes (such as frozen or closed), behavior scores or credit bureau scores, and age of the account. Some banks use an approach that is based on a calculation of historical loss rates for similar loans. The bank calculates actual annual loss rates for current loans over the past 12 months (perhaps stratified by score) and applies those loss rates against the applicable outstanding balances of current loans.

Roll-rates sometimes evidence aberrations due to a variety of factors (some of which are consistent with the bullet points in the Considerations to Accompany a Methodology section). Examiners should expect management to be able to explain any significant aberrations in roll-rates as well as how it is addressing those aberrations in the methodology.

Roll-rate methods and reporting continue to evolve. For example, management now usually conducts roll-rate analysis for each portfolio segment. Also, roll-rate methods frequently had been based on gross balances, but more recently, banks are developing roll-rate models that track principal balances and separately track fee and interest balances in an effort to better understand charge-offs and the associated allowances that are necessary. For subprime credit card loans, a large portion of the final loss amount usually consists of fees and interest. Some subprime lenders use unit roll-rates instead of dollar roll-rates to remove the inflation effect caused by interest and fee accruals in the later delinquency buckets. The units are converted to dollars at some point in the calculation. Using units in the methodology is not a problem, but the examiner should ensure that this added step does not somehow cause an understatement of estimated credit losses. It would generally only be appropriate to use units if the portfolio is very homogeneous and all accounts have roughly the same balance and risk profile. Also, if interest and fees are removed from the analysis, the methodology will need a separate calculation for those items. Fee and interest allowances are discussed later in this chapter.

Average Charge-Off Method

The average charge-off method is a simplified approach that generally is used to supplement other methodologies. The average charge-off method provides an estimate of annual charge-offs based on past performance. Both monthly charge-offs and monthly outstanding receivable balances for a specific time period are collected and averaged to calculate the charge-off ratio. The time period chosen is usually three months, six months, or longer, but should be long enough to smooth out any impacts from significant growth factors, changes in underwriting or lending practices, deteriorating trends in the volume of past due credits, and changes in current local and national economic conditions. This smoothing reduces dramatic, temporary shifts in the level of estimated allowance requirements. To arrive at an estimate of annual projected charge-offs, the outstanding receivables balance is multiplied by the average charge-off ratio.

This method is also generally easy to apply when the portfolio is divided into subgroups (historical loss rates for the applicable segment would be applied against the segment). For example, historical loss rates by credit score band could be tracked and applied to the outstanding balance of each band on the date of evaluation. The portfolio could be segmented many ways, including behavior score or vintage (age). Other advantages are that the data needs are relatively modest.

A weakness in this approach is that it assumes that future loss rates will be similar to historical experience. The judgmental nature of the process also introduces potential bias if forecasters rely on longer-run averages when conditions are deteriorating and on short-run trends at the earliest signs of recovery, either of which results in lower loss estimates. Examiners should assess management’s use of averages to ascertain the impact that the selected averaging periods may have on the level of allowances.

Vintage Analysis

With vintage analysis, projected losses are determined based upon the age of accounts. This approach helps to eliminate the distortion caused by rapid growth and the credit card loss curve. Typically, only nominal losses are incurred during the first six months after a vintage is booked. However, months 7 through 9 often have the highest loss rates, followed by a gradual declining trend in months 10 through 15. A lot of vintages reach some sort of stabilized loss rate somewhere around month 18. Thus, accounts that will be aging through the highest point of the loss curve in the near future would probably require the highest allocation while accounts in the later vintages would normally require lower allocations. Loss curves vary depending on the quality of underlying accounts and should be reviewed on a case-by-case basis. Normally prime portfolios experience peak losses later than subprime portfolios.

Patterns or curves are generally predictive for future vintages, provided adjustments are made for changes in underwriting criteria, line increases, economic conditions, and so forth. Examiners should assess management’s practices for adjusting loss estimates promptly when the performances of new vintages deviate markedly from past curves and trajectories or if other changes, either internal or external, occur.

Regression Analysis

Regression analysis uses national economic data such as unemployment and bankruptcy rates, the retail sales to personal income ratio, and the consumer debt-to-income ratio. The models also use internal data such as behavior score distributions and delinquency rates. The information is synthesized by trained statisticians to forecast loss rates. However, before employing a loss estimation model that is based on regression analysis, management should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, banks that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the support for adjustments to the model or its results. Because of the complexity of the models and the need for highly-trained personnel, regression analysis is not widely used.

Portfolio Liquidation Method (or Payment Turnover Method)

The portfolio liquidation or payment turnover method calculates an allowance amount equal to estimated charge-offs over the estimated average life of the credit card portfolio balance. Management uses one or more of the other common methods to calculate estimated credit losses for the next 12 months. It then adjusts the figure downward based upon its assumption that the average life of a credit card balance is less than 12 months. If a bank is using turnover to support an allowance level significantly below a 12 month equivalent, examiners should carefully review the related documentation. Turnover is not directly addressed by GAAP or regulatory guidelines, and careful consideration should be given to the factors discussed in the Considerations to Accompany the Methodology section.

Management often contends that credit card balances have a very short life, even if the account has a longer life. Some banks calculate the average life of a revolving receivable by simply dividing total receivables by aggregate gross monthly payments. This approach assumes that each payment received would probably extinguish a sizable portion of the original balance, even though subsequent principal advances are often being made on the same credit card account and fees and interest charges are typically absorbing much of the payment. The average life of a receivable extends, however, when it is calculated by using a netting approach in which the original loan balance is considered paid down only to the extent that payment is greater than subsequent principal advances and interest and fee accruals. The netting of payments and subsequent charges assumes that risk is not extinguished until the loan has been paid off and that risk is not declining proportionally to the gross payment amount. Because the **payment hierarchy** typically applies payments to fees and interest charges first, the capitalized balance on the account does not really turnover as quickly as the non-netting approach would imply.

CONSIDERATIONS TO ACCOMPANY THE METHODOLOGY

Examiners should determine whether estimated credit losses reflect consideration of all significant factors that affect the card portfolio's collectibility as of the evaluation date. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an adequate allowance. Examiners should also assess whether management considers any factors that are likely to cause estimated losses to differ from historical loss experience, including, but not limited to:

- Changes in lending policies and procedures, including underwriting, collection, charge-off, and recovery practices.

- Changes in local and national economic and business conditions.
- Changes in bankruptcy rates.
- Changes in the volume or type of credit extended.
- Changes in the experience, ability, and depth of lending management.
- Changes in the volume and severity of past due, nonaccrual, workout, adversely classified, or similar loans.
- Changes in the quality of the loan review system or the degree of oversight.
- The existence of, or changes in the level of, any concentrations of credit.
- The accuracy of credit scoring or other scoring systems used.
- The effect of external factors such as competition and legal and regulatory requirements.

The review of the written allowance analysis is aimed at determining whether it adequately documents the factors considered in evaluating the portfolio, including, but not limited to:

- Portfolio segmentation methods.
- Loss estimation techniques and assumptions.
- Definitions of ratios and model computations.
- Baseline loss information used.
- Rationale for adjustments to historical experience.
- A comparison of estimated credit losses as of a financial statement date to actual subsequent charge-offs, with significant variances explained (often referred to as back-testing).

Ratio Analysis

Use of ratio analysis as a supplemental check for evaluating the overall reasonableness of allowances is encouraged. However, ratio comparisons are not, by themselves, a sufficient basis for determining an adequate allowance level and do not eliminate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility. Examples of common ratios and their uses include:

- *Allowance to Total Loans and Leases (correspondingly Credit Card Allowance to Total Credit Card Loans)* – Differences among banks in the composition of loan portfolios, in underwriting and collection policies and practices, and in charge-off practices make comparison of this ratio among banks an unreliable indicator of allowance adequacy. But, an upward or downward trend in this ratio for an individual bank suggests a need for further investigation as to why the relationship is changing.
- *Allowance to Net Losses (correspondingly Credit Card Allowance to Net Credit Card Losses)* – For the reasons listed in the prior bullet point, comparing this ratio among banks is also unreliable. Even within a bank, charge-off rates may vary widely from year-to-year, and comparisons of the relationship between the bank's current allowance and short-term averages of its net losses could be misleading. If the bank's allowance has been stable or declining, while its net loan losses have been trending upward, the adequacy of the allowance may be suspect.
- *Earnings Coverage of Net Losses (correspondingly Credit Card Portfolio Earnings Coverage of Net Credit Card Losses)* – Regardless of whether earnings are sufficient to cover losses and replenish the allowance, situations in which the bank’s annual net charge-offs substantially exceed the allowance balance should be inspected.
- *Recoveries to Average Total Loans and Leases* ratio and *Recoveries to Prior-Period Losses* ratio (correspondingly *Credit Card Recoveries to Average Credit Card Loans* ratio and *Credit Card Recoveries to Prior-Period Credit Card Losses* ratio) – These ratios are affected by the bank's charge-off policy because quicker charge-off practices typically result in higher recovery rates, while low recovery rates might be a sign that the bank is

slow to charge-off losses. The ratios provide little information relating to the adequacy of the allowance (other than the potential reasonableness of recovery assumptions used in the allowance methodology), but gives some insight into whether, and how effectively, the bank works to recover on its charged-off loans.

Layering

Layering of allowances is inappropriate. Layering happens when a bank includes a loan in one segment, determines its best estimate of loss for that loan (either under FAS 114 or on a group basis under FAS 5), and then includes the loan in another group that receives an additional allowance amount. Loss estimates from both accounting methods (the line-by-line approach under FAS 114 and the group approach under FAS 5) must be consolidated to determine the appropriate level of the allowance but, double counting by applying FAS 114 and FAS 5 to measure the same loss in the same loan again is inappropriate. As such, management must ensure that groups of loans appropriately exclude individual reviewed loans that are deemed to be impaired and have had individual allowances established in accordance with FAS 114.

Ownership Interests

Banks are not permitted to hold loan loss allowances against loans that have been sold or otherwise transferred off the balance sheet. Instead, consideration of securitization in allowance calculations usually involves ensuring that the performance of the securitized accounts is not unduly influencing the allowance levels held by the bank. Many methodologies are based on managed roll-rates, and, as such, require adjustment for the securitized loans. Examiners should determine how the risk profile of the owned loans compares to that of the securitized loans (or similarly to other loans issued by the bank but held elsewhere, such as through Rent-a-BINs). It is not uncommon for the sold receivables to perform differently, and in many cases, better than those retained by the bank. In these situations, it is inappropriate for a bank to use managed portfolio performance in assessing necessary allowance amounts for owned loans. Generally, allowance calculations should segment managed receivables into different ownership interests to isolate the performance of each of the segments. Banks must account for the owned portion of accrued interest and fees, including the associated estimated losses, separately from the retained interest in accrued interest and fees related to securitized credit card receivables.

Settlements

The AMG addresses allowances for settlement accounts. Management is to establish and maintain adequate loss allowances for credit card accounts subject to settlement arrangements. The amount of debt forgiven in such an arrangement should be charged-off immediately, but if impractical, banks may instead treat the forgiven amount as a specific allowance, which should be reported in the same manner as an actual charge-off.

PURIFICATION AND ALLOWANCES FOR INTEREST AND FEES

At the time of charge-off, most credit card banks charge only a portion of the gross loss against the ALLL. That portion generally relates to the principal balance of the credit card loan. The remaining amount, which consists of fees and interest, is charged directly to the income statement and not to the ALLL. The process is called purification and generally does not occur on a loan-by-loan basis. Instead, management usually performs a study to make an estimate of the typical amount of interest and fees. These average percentages are then used for all similar credit card loans. Most methodologies are designed to predict gross losses, with a subsequent adjustment for purification that will derive estimated principal losses.

The Call Report specifies that in determining estimated credit losses, management must evaluate the collectibility of the loan portfolio, including any recorded accrued and unpaid interest. Call

Reports require banks to report the gross amount of loan losses, including those balances that have been purified. These gross loss amounts need to be adequately provided for either in the general ALLL or a combination of the general ALLL and separate allowances for estimated losses on capitalized fee and interest charge accruals. Failure to establish appropriate allowances for uncollectible fees and interest charges can result in a material overstatement of capital levels. The *Expanded Guidance for Subprime Lending Programs* clearly states that estimates of credit losses should include accrued interest and other accrued fees that have been added to the loan balances. For subprime banks, this amount is likely to be significant.

Per the AMG, the owned portion of accrued interest and fees must be accounted for separately from the retained interest in accrued interest and fees related to securitized card receivables.

UNALLOCATED ALLOWANCES

Banks are required to consider qualitative factors in the credit card loss estimate analysis, but this generally is part of an overall disciplined approach and not as part of developing a cushion to prevent fluctuations of income. Although establishing allowances that are labeled under “unallocated” is a long-standing practice in the industry, the term “unallocated” is not defined in GAAP. In some cases, the creation of unallocated allowances has been based on the premise that unexpected conditions could cause losses to exceed estimated credit losses. However, banks should not carry unallocated allowances that have been established for this reason because an unallocated allowance is appropriate only when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported. In this regard, the risk of unexpected losses should be covered by equity capital, not by the allowance.

There are cases, however, where unallocated allowances may be appropriate. Specifically, there are events that are known to have occurred that can reasonably be expected to cause future charge-off rates to exceed the level derived by the quantitative methodology. Several qualitative factors could be considered, including these examples:

- Economic Conditions - In a period of economic weakness, it may be appropriate to carry additional allowances to offset the likelihood that future loss rates will exceed historical levels.
- Material Change in Business Plan, Policies, or Practices - For instance, entry into a new or potentially risky market segment or a change in account management or collection strategies that might affect roll-rates could warrant additional allowances.
- Change in Portfolio Composition - If the methodology is based on historical experience, events or conditions that could cause future results to be different should be considered. For instance, additional allowances may be necessary if:
    - The bank is aggressively adding new accounts because new accounts generally have much higher loss rates.
    - Line increase programs have raised the average balance.
    - Deterioration in credit or behavior score distribution is noted.
    - Portfolio acquisitions are materially impacting portfolio performance.

These are just a few examples of possible conditions that might warrant unallocated allowances. A close relationship sometimes exists between adjustments that management makes to roll-rates or other predictors in the methodology and other adjustments that it makes for unallocated allowances. Management is expected to carefully document its assumptions used, both for changes made to specific predictors and for any amounts set aside as unallocated allowances.

ALLOWANCES FOR UNFUNDED LOAN COMMITMENTS

Probable credit losses associated with unfunded loan commitments should be accrued and an allowance for off-balance sheet credit exposures recognized as a liability (and not part of the

ALLL) when the conditions in FAS 5 are met. Normally, banks determine the adequacy of credit card allowances based on outstanding credit card receivables rather than on committed credit lines. However, management is responsible for determining whether probable losses related to undisbursed funds exist and for estimating the amount of any liability that is needed. Examiners ordinarily do not take exception to management's conclusion that the FAS 5 conditions for accrual of a loss have not been met, and therefore no liability is needed if an effective monitoring and control system identifies deteriorating credits at an early stage and freezes, cancels, or reduces those lines in a timely manner. Many banks with credit card portfolios do not record a liability for loan commitments premised on the ability to cancel commitments within a relatively short timeframe. Also, in many subprime portfolios high utilization rates result in relatively small loan commitments or available credit amounts.

VALIDATION

Banks are required to validate the allowance methodology, as depicted in the *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*. The methodology is only considered valid when it accurately estimates the amount of loss contained in the portfolio. As such, the methodology should include procedures that adjust loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs as needed. Examiners should determine whether the bank's policies and practices include procedures for a methodology review by a party who is independent of the loss estimation process, methodology, and its applications. Examples of practices that banks employ when validating the methodology include:

- Reviewing trends in loan volume, delinquencies, restructurings, and concentrations.
- Reviewing charge-off and recovery histories, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- Reviewing, on a test basis, source documents and underlying assumptions.
- Evaluating the appraisal process of any underlying collateral.

Management usually supports the validation process with workpapers from the review function. Additional documentation often includes the summary of findings of the independent reviewer. If management changes the methodology based on findings of the validation process, it should maintain documentation that describes and supports the changes.

As a simple validation test, examiners could compare the allowance on any given date against actual charge-offs that were recorded over a subsequent 12-month horizon. Significant differences would need further investigation, and examiners should look to management to explain differences between estimated losses used in determining the allowance and actual charge-offs taken. If management claims the difference is due to the build-up of fees and interest charges and charge-offs on new accounts opened subsequent to the financial statement date considered, examiners should review management's supporting documents to confirm whether this is actually the case.

SUMMARY OF EXAMINATION GOALS – ALLOWANCES FOR LOAN LOSSES

The determination of appropriate credit card loss allowances requires examiners to thoroughly review documentation to ensure that the methodology is comprehensive and appropriately considers the bank's loss experience and current conditions. Examiners should:

- Consider the quality of the bank's review system and management in identifying, monitoring, and addressing asset quality problems.
- Assess management's allowance evaluation process, including the assumptions used. Determine whether all significant factors that affect the collectibility of the portfolio are appropriately considered.

- Review the overall level of allowances and the range of estimated credit losses for reasonableness in regards to the various factors discussed in this chapter.
- Perform quantitative analyses (several are noted in this chapter) as a check for reasonableness and determine the reasons for any differences between the results of the analyses and the bank's allowance.
- Review the adequacy of documentation maintained for supporting the appropriateness of allowance levels. This should include documentation of validation processes and findings.
- If necessary, independently prepare a variety of evaluation approaches which can be used to develop a range of estimated losses and comparative analyses.
- As necessary, discuss differences with management and the bank's external auditors.

XIII. ASSET QUALITY CONSIDERATIONS

Asset quality impacts many facets of bank operations and is one of the most critical factors in determining the bank's overall condition. The quality of the loan portfolio, including credit card portfolios, and of credit administration programs normally have a substantial effect on asset quality because loans are usually the largest of the asset items, and they can carry the greatest amount of potential risk to capital. Review of the credit card portfolios is carefully rolled into the comprehensive review of asset quality. Problems within the card portfolio can detract from management's ability to successfully and profitably manage other bank activities.

The asset quality rating incorporates the quantity of existing and potential credit risk associated with the credit card portfolio(s) and the ability of management to identify, measure, monitor, and control that credit risk. It should consider the adequacy of allowances for credit card losses and all other risks that may affect the value or marketability of the card portfolio, including, but not limited to, operating, market, reputation, strategic, or compliance risks. Prior to assigning the overall asset quality rating, examiners should consider several factors within the context of any local, regional, or national conditions that might impact the card portfolio and, consequently, bank performance. Also, examiners should give any systemic weaknesses appropriate consideration. The following list is not exhaustive but does provide factors to consider when determining the quality of the credit card portfolio and, consequently, asset quality:

- Appropriateness of marketing programs, the inherent risks of target markets, and the suitability of risk selection practices.
- Adequacy of credit card underwriting standards.
- Soundness of credit card administration practices, including for account management, and management's ability to appropriately establish and conduct those practices.
- Level, distribution, severity, and trend of over-limit, adversely classified, nonaccrual, workout, and other problematic credit card receivables/accounts.
- Adequacy of credit card allowances, including the ALLL and any other types of allowances.
- Diversification of the credit card portfolio, including the existence of concentrations.
- Support (or lack thereof) of any underlying collateral, the control over collateral, and other credit risk mitigants.
- Adequacy of policies and procedures for the areas of credit card operations.
- Volume and nature of exceptions and overrides.
- Level of compliance with regulatory and other credit card lending guidance.
- Adequacy of internal controls and MIS.
- Profitability of credit card portfolios or portfolio segments.
- Consideration of the impact of portfolio purchases and/or sales.
- Credit risk from off-balance sheet activity, such as unfunded credit card lines.

Factors should be evaluated not only according to the current level but also to any ongoing trends. The same level might be looked on more or less favorably depending on any improving or deteriorating trends in one or more factors.

Key indices can be beneficial in determining the quality of the credit card portfolio. If properly developed, management's basic suite of reports (usually prepared at least monthly) should be able to aid examiners in identifying most of the key indices. The reports, as discussed in the Portfolio Management chapter, should usually be prepared for each portfolio segment to help gauge performance within that segment or to the managed portfolio. Examiners also frequently develop their own reports (or spreadsheets) based on management's reports and any relevant information gathered during the examination.

SUMMARY OF EXAMINATION GOALS – ASSET QUALITY CONSIDERATIONS

Examiners must determine the quality of the credit card portfolios, including consideration of the adequacy of allowances, the quantity of credit risk within the card portfolios, and the quality of credit risk management of the portfolios. Examiners then consider that risk in the overall assessment of asset quality, which includes assessments of other asset components (for example, traditional loan portfolio and securities) as applicable. Some specific considerations to determine the quality of the credit card portfolios are listed in the bullet points earlier in this chapter. In summary, examiners should:

- Consider examination findings from the various credit card operational areas (marketing, underwriting, portfolio management, and so forth).
- Consider the level of and trend in key indices, such as those for delinquencies, charge-offs, workout programs, and so forth. This process will likely entail reviewing a series of management reports on various portfolio segments.
- Consider the level, trend, and severity of adversely classified credit card receivables.
- Consider the status of prior examination findings related to credit card portfolio quality.

Numerous potential red flags are named in preceding chapters of this manual. Examiners might identify the following situations which may be red flags from a broader perspective and warrant additional follow up, potentially in the subcomponent review areas for credit card activities:

- Existence of higher-risk programs, such as those targeting subprime borrowers and/or borrowers with no or limited credit histories.
- Concentrations, such as in subprime receivables.
- Unproven product models, or changes to the models without sufficient testing periods.
- Rapid growth in the credit card portfolio.
- Changes in underwriting standards or risk selection practices that broaden the range of the customer base to a higher-risk population.
- High or increased levels of adversely classified credit card loans.
- Increased severity of classifications.
- Less than full compliance with regulatory and/or other guidance governing credit card lending activities.
- Failure by management to address prior examination or audit concerns.
- Re-booking of charged-off assets.
- Compensation programs that fail to reinforce management's responsibility to properly administer, analyze, and report the risk in credit card portfolios.

XIV. CREDIT CARD ISSUING RENT-A-BINS

Banks are involved in many business lines that have varying competitive pressures and requirements for success. They are increasingly evaluating each line to determine whether it makes the most of the bank's strengths and is consistent with its strategic plans. As management considers these evaluations, it may decide to stop activities that are not profitable or that are too high-risk for its appetite in order to concentrate on activities that may be more profitable, that it and the bank may be better-suited for, or that are lower-risk. These types of evaluations have led to the development of many variants of the credit card lending model, one of which is a Rent-a-Bank Identification Number (BIN) arrangement. This chapter describes Rent-a-BIN (RAB) models and structures, highlights the risks of issuing RAB arrangements, and discusses risk-mitigating controls that management typically employs. Later sections of the chapter consider topics such as capital and accounting.

RENT-A-BIN MODELS AND STRUCTURES

With a RAB arrangement, a bank allows one or more other entities to conduct credit card activities with or through one of the bank's BINs[8], which is a number assigned by an Association to identify the bank for authorization, clearing, settlement, card issuing, or other processes. In return for allowing the use of its BIN, the bank receives a "rental" fee from that entity, hence the term Rent-a-BIN.

There are essentially two types of RAB arrangements: a credit card issuing RAB and an acquiring RAB. Each has a unique set of risks but both require the bank to have strong vendor-oversight programs. Acquiring RABs, which draw their names from the arrangement's feature of acquiring merchant contracts and cardholder transactions, are addressed in the Merchant Processing chapter, and issuing RABs, which draw their names from the arrangement's feature of issuing credit cards to consumers, are the focus of this chapter.

There are several common features among issuing RABs. In an issuing RAB arrangement a bank (as BIN owner) rents its right to offer credit cards that have the applicable Association's logo to a third party for a fee. The third party generally solicits prospective credit card customers and then provides approved applicants with a credit card. The bank is identified as the issuer of the card while the BIN-renter, or partner, and other sub-contracted participants may not necessarily be apparent to the cardholder. The bank retains its contract with the Association(s) because the Associations only allow insured depository institutions to issue credit cards under their brands. While the bank sheds itself of a majority of the day-to-day operational duties associated with operating the program in most cases, it always retains ultimate responsibility for the program based on its contract with the applicable Association and on it being the issuer of record.

Issuing RABs also have several aspects that vary from arrangement to arrangement. For example, the receivables are usually held by the BIN-renter (partner) or another party. In a few cases the bank might hold a small portion of the receivables or even a majority or all of the receivables. Securitization of the program's receivables (by whichever party has funded those receivables) may or may not be present. In most cases, the partner is unaffiliated with the bank. However, the partner may be an affiliate of the bank or a related interest of an insider of the bank, requiring an additional layer of review. Furthermore, some banks have arrangements with more than one partner for different credit card programs/BINs. Portfolio services such as collections,

[8] As mentioned in an earlier chapter, an ICA is a number assigned by MasterCard and is similar to a BIN that is issued by Visa. ICAs and BINs are collectively referred to as BINs in this manual. This chapter references arrangements involving the Associations; but, similar arrangements may be encountered with other networks going forward, particularly now that Discover and American Express are expanding their bankcard markets.

customer service, and processing, can be performed by the partner or by other third-parties (which, again, may or may not be affiliated with the bank). The bank could even perform select services or processes. In most cases the bank is an issuer only, but it is plausible that it could be both issuing and acquiring, which could complicate matters (refer to the Merchant Processing chapter for information on the acquiring business).

A bank might enter into an issuing RAB to reduce or to limit the level of receivables held on its balance sheet (thus reducing or limiting on-book credit risk) and/or to reduce or limit the operating burden on internal resources while still generating income from credit card activities. While issuing RAB arrangements can be effective means of meeting these goals, they pose a number of risks to the bank, and those risks can be substantial. Problems commonly arise when management is overly focused on apparent returns or cost savings or when it lacks sufficient knowledge about the risks involved with the card products offered, RAB activities, and/or third-party oversight.

A primary concern with RAB arrangements is that the bank may not have sufficient controls over the partner's (or the partner's agent's) actions, particularly solicitation, underwriting, and administration of the credit card relationships. The quality of services provided by the hundreds of third-parties in credit card and related industries, as well as their wherewithal to support the activities, varies widely. If the partner or its agents fail to abide by applicable laws, guidance, and regulations, or if the partner experiences financial difficulties, the bank could be exposed to operation and reputation risks that may result in fines or other monetary losses, funding or liquidity risks if the partner or other receivable-holders are not able to provide funding for new charges that they have committed to fund, and credit risk if the bank must fund the cardholder charges and retain the receivables on its balance sheet. Credit risk, whether from receivables voluntarily retained or that the bank is forced to retain, could be substantial if the bank has not had proper control over the partner's underwriting criteria and the partner solicited and accepted customers with riskier profiles than what the bank would normally accept.

For purposes of this chapter, a simple structure will be used: the bank will be an issuer (and not an acquirer) and will generally be assumed to be contracting with one partner, and that partner will hold all card receivables as well as perform all servicing and processing for the portfolio. However, examiners should keep in mind that a bank may have more than one partner, that the partner might have relationships with more than one bank, that the bank may or may not retain the receivables, and that servicing may be performed by the partner, the bank, or another third-party. Examiners will need to review governing documents for issuing RAB arrangements (normally for those that are material or new) to ascertain the parties involved, the extent of each party's responsibilities, and how and to what degree failure of each party to meet its obligations may impact the bank, whether directly or indirectly. Examiners should also look for evidence identifying whether management has properly addressed the risks from each RAB arrangement.

RESPONSIBILITIES OF BANK MANAGEMENT

Management sometimes assumes that it does not have to carefully monitor the card portfolio, namely when the bank does not hold the receivables. However, in an issuing RAB arrangement, the bank is responsible for the program and its customer relationships regardless of where the receivables reside. Further, the performance of the accounts can substantially impact the risks to the bank. Another misconception is that if a contract is in place between the bank and the partner, the bank is sufficiently protected. Contracts, a necessary component of a successful RAB operation, may not always be iron-clad. For example, the partner's indemnification contribution is only as strong as its financial wherewithal. Further, in some situations the bank might step in and relieve the partner from some of its responsibilities under the contract, thus tainting the contract. As another example, even though the contract might call for the partner to reimburse fines, it is up to the bank to seek that reimbursement and it might elect not do so, perhaps to keep the third party viable or to avoid disruptions to the program. That is not to say that a partner could not also provide services or financial support beyond contract specifications.

Even though the bank might not be directly involved in solicitation, underwriting, and administration processes under the issuing RAB arrangement, it is still the legal owner of the card accounts and relationships. As the BIN-licensee, the bank is responsible to the Association(s) for transactions processed and/or cards issued with its BINs, and, thus, program oversight. Even though contracts between the bank and the partner might direct the partner to assume these and other responsibilities, regulatory agencies and, most likely, the Associations regard the bank as ultimately responsible for the program. Typically the Associations have nominal direct contact with the bank's third parties. Rather, the bank is responsible for managing the third-party relationships, ensuring the third party meets established standards, and looking to the partner for reimbursement or other support provided for in the contract between the bank and the partner. The Association(s) may look to the third party if the bank is unable to meet its obligations.

Rigorous and thorough oversight of issuing RAB arrangements is warranted for management to ensure the risks are appropriately controlled. Issuing RAB relationships should generally be subject to risk management, consumer protection, and other policies and practices consistent with those that would be used if the bank was issuing the cards directly. The assessment of controls, safeguards, and practices for RAB activities is factored into the Management component rating (and other component ratings as applicable).

RISKS

Issuing RABs can be profitable ventures but do entail risks which, if not properly controlled, can quickly erode profitability and/or cause many other problems, some of which could be critical, for the bank. Because the bank does not usually hold the preponderance of the receivables and because third parties are typically conducting most of the portfolio services, the risks may not appear as straightforward as they are with a conventional credit card lending model. The frequency and level of each risk to a RAB bank is influenced by a number of factors, including, but not limited to, the type of card program, the bank's experience with the program or similar programs, and the third party's experience with similar activities. Poor planning, oversight, and control by management and inferior performance or service by the partner are usually the culprits that increase the risks.

Due to the risks involved, RAB arrangements warrant carefully-orchestrated, management-appointed safeguards and controls. Examiners should determine whether management, even if only considering establishing an arrangement, is fully aware of the risks involved. They should look for evidence that management has identified and documented the business's risks as well as the expertise and controls that will be required to manage those risks. A formal risk assessment may be warranted, particularly when proposed RAB activities will be of a substantial volume or would involve higher-risk characteristics, such as subprime lending or new products. Risks with an issuing-RAB arrangement include, but may not be limited to, legal, compliance, and reputation risks; counterparty risk; funding risk; credit risk; and operational risk.

Legal, Compliance, and Reputation Risks

Legal, compliance (consumer or otherwise), and reputation risks are prominent in issuing-RAB arrangements. These risks can be particularly substantial when subprime lending or other high-risk activities are involved. While these three risks often go hand-in-hand, they are not synonymous. These types of risks arise because the bank is responsible for the program, including actions taken (or inaction) by the third-parties involved. The bank cannot effectively detach itself from the credit card activity since the bank's name remains as the card issuer and the bank remains contracted with the Associations. Thus, errors and violations of law or of cardholder agreements, by the bank or its contracted parties, could expose the bank to substantial monetary loss through lawsuits, fines, or other financial burdens. Consumer compliance risks, which can easily translate into safety and soundness risks, can be exacerbated when the partner's (or its agents') employees interact directly with the bank's customers. For example, if marketing of the card program by the bank, the partner, or a third party is determined to be unfair or deceptive, the bank may be held responsible for any monetary penalties, reimbursements, and any other actions (such as shutting down the program) necessary to promptly address the concerns. As a result, risks to the bank's earnings and capital could ensue. The bank's reputation can also suffer by association with improper or abusive business practices conducted by the partner or its agents. Third parties' decisions may affect a bank's ability to establish new relationships or continue existing relationships, which could impact the bank's strategic objectives.

In general, the bank and its credit card programs must remain compliant with laws, regulations, and guidance including, but not limited to, the *Account Management and Loss Allowance Guidance for Credit Card Lending* (AMG), consumer protection laws, and anti-money laundering laws. The AMG is generally applicable to all insured institutions that offer credit card programs, regardless of whether or not the receivables are held at the bank. Further, banks' obligations to comply with the Associations' standards are not limited by the receivables' place of residence.

The Associations are highly cognizant of their own reputations. If the card program demonstrates increasing or high risk, inadequate controls, or high volumes in relation to the bank's size and resources, the Associations may require the bank to put up additional capital or collateral for the card program, regardless of where the receivables reside and regardless of whether or not a RAB arrangement is involved. Abuses of a bank's Association membership (including of the by-laws and operating regulations thereof) by a partner or its agents could also cause the bank to lose its authority to issue cards under the Associations' brands. Such a loss could impact the bank's reputation, earnings, and liquidity; could ultimately translate into capital problems for the bank; and/or could require substantial revisions to the bank's strategic objectives.

Regulators may also require augmented capital levels. The necessary level of capital is based on a number of factors, as discussed later in this chapter.

Counterparty Risk

Counterparty risk, or default risk, is the risk that the partner will fail to perform on its contractual obligations. It often ties closely to performance of the card portfolio because the partner's earnings and, thus, capital maintenance, formation, and support, is frequently a product of income generated by and costs associated with the program. The partner usually retains most of the program's income and carries most of the costs when it holds most or all of the receivables.

The partner could fail to meet its obligations under the contract(s) governing the RAB arrangement. For example, the partner might fail to fund the receivables, pay the rental fee, comply with established financial covenants and/or portfolio parameters, or maintain sufficient collateral support. As a result, the bank could have to fund the receivables, potentially increasing its liquidity, credit, and other risks. The bank might not be able to offset its oversight, management, or other costs for the program, which could stress the bank's earnings performance and, consequently, capital.

Funding Risk

Funding risk stems from the bank's responsibility to ensure that settlement[9] requirements are met. Funding risk, however, could be considered, in some respects, to be a by-product of

[9] Settlement is the term used to refer to the exchange of the actual funds for the cardholder transactions and associated fees. The issuers normally remit funds, through the Associations, to the acquirer, and the acquirer pays the individual merchants. Settlement is discussed in the Merchant Processing chapter.

counterparty risk. Usually the bank settles directly with the processor, whether or not the bank retains the receivables. Even if the partner or other third party is required by the RAB contract to fund settlement and/or may be able to settle directly with the processor, the bank is ultimately responsible to the Associations for ensuring settlement is met as it is the BIN-licensee and the issuer. Consequently, when funds available from the partner, which are usually influenced heavily by cardholder payments, cannot fully meet settlement requirements, the bank is looked upon to make up the difference.

Further, when the partner possesses the receivables, it could subsequently be selling those receivables via securitization. The securitization vehicle must be maintained whether or not the partner is able to fund or acquire the receivables and sell receivables to the securitization vehicle. Further, poor performance of the securitized portfolio could trigger cash capture or early amortization. In these cases, the trust will use incoming cardholder payments as applicable to fund **spread accounts**, pay off the investor certificates, and so forth. Since those funds will not be available to the partner to fund settlement, the bank could have to furnish funds.

Credit Risk

Credit risk remains at the bank for any receivables it retains. Credit risk also arises, albeit off-balance sheet or contingent, if receivables are held by the partner or another entity. Credit risk could shift to the bank if the receivables-holder cannot fulfill its financial obligations, such as settlement, and could be substantial if the bank has not properly controlled the partner's underwriting criteria and the partner has solicited accounts with risky profiles.

Operational Risk

Operational risk is generally defined as the risk of monetary loss resulting from inadequate or failed internal processes, people, and systems or from external events. Examples include fraud, business disruption, and poor execution of process management and can all have adverse impacts on the bank and its RAB programs. Comprehensive due diligence and contingency planning, including stand-in arrangements, can help limit the level of and impacts from operational risk.

RISK-MITIGATING CONTROLS

Practices and safeguards that management commonly implements to mitigate risks include, but are not limited to, instituting policy controls, performing due diligence procedures, establishing a comprehensive contract between the bank and the partner, and developing detailed contingency plans. Without proper safeguards in place, exposure could be substantial.

Policies

As part of being contractually responsible for and controlling the program, management normally establishes a thorough review and approval process for policies proposed or used by the partner. An effective RAB contract sets forth the bank's expectations regarding the partner's operating policies applicable to the program and provides bank management with the stated authority to periodically review the policies (both prior to and after implementation) to ensure the policies are consistent with the bank's standards and risk tolerances. Examiners should determine whether policy reviews are well-documented and whether a formal agreement process for program policies is used.

Examiners' attention should be directed to situations in which the bank's internal policies fail to specify a system for approving partners and an ongoing program to monitor the partner's financial condition and operating performance as well as portfolio performance. In general, a comprehensive policy designates the criteria for selecting partners, stipulates information that is required in the RAB contract, and addresses other items, such as limits per RAB relationship and concentration limits.

Examiners' attention should also be directed to cases in which policies (whether the bank's or the partner's) are not consistent with the scale of the activity and the risks it presents. Typically the bank does not diverge from its normal lending practices when participating in RAB relationships. But, if the bank significantly diverges from its normal lending practices, examiners should assess how management has ensured that any eased standards still result in an acceptable level of credit risk and that any elevated risks are appropriately addressed. Failure to adequately control policies used by the partner could result in compliance and legal risks to the bank. Further, it could cause the partner to take on more risk, including credit risk, than it can control, and that risk could fall back on the bank if the partner is unable to meet certain financial obligations.

Due Diligence

Risk exposures generally increase when the bank is contracting with a disreputable or inexperienced partner. As is the case for any third-party arrangement, selecting a competent, qualified, and reputable partner is essential to effectively managing the arrangement's risks. Examiners should look for evidence that the due diligence process is structured to identify qualitative and quantitative aspects, both financial and operational, of the partner and to assess the arrangement's consistency with the bank's strategic goals. To be effective, due diligence should occur before conducting business or contracting with the entity, and at appropriate intervals thereafter, such as when the contract is due for extension or renewal.

Facts should corroborate that, before entering into or re-negotiating a RAB agreement, management ensured that the prospective partner had adequate financial capacity, expertise, infrastructure, technology, and staffing to operate the program soundly. In general, a thorough due diligence process includes documentation of these items:

- Analysis of credible financial information on the entity as well as its principals to verify the entity's viability and capacity to absorb losses.
- Research of background information and reputations of the entity and its ownership. This process may include reviewing business reputation, complaints, and litigation (such as by checking references or contacting attorney generals' offices and Better Business Bureaus). The length of time the entity has been in business is also applicable.
- Performance of a first-hand, on-site evaluation of the entity's business operations, including its premises and relevant records, to ensure it has the proper facilities, equipment, personnel, and so forth.
- Review of the entity's management experience in implementing and supporting the proposed activity as well as other relevant qualifications.
- Evaluation of the entity's business resumption, continuity, recovery, and contingency plans.
- Assessment of the entity's reliance on and success at dealing with sub-contractors, and resolution of which sub-contractors management will conduct due diligence of.
- Determination of whether appropriate insurance coverage is in place.
- Assessment of whether the entity's culture, values, business style, and strategies fit with the bank's culture, values, business style, and strategies.

In-House Expertise

Because of the risks associated with issuing RABs and to ensure the RAB operates successfully, it is imperative that the bank devote knowledgeable staff to oversee the arrangement. Examiners should assess the board of directors' practices for identifying the bank positions needed and clearly assigning responsibility for overseeing the partner and its operations. They should determine whether the bank has provided adequate personnel and resources to fulfill its obligations in regards to the program and to monitor the partner's activities and portfolio performance. Examiners should look for proof that the bank's designated staff is knowledgeable and experienced with the processor, software programs, and other devices used by the partner and has legal and compliance expertise as well as accounting and technology expertise relevant to credit card lending. If the bank services the portfolio, proof should confirm whether it has adequate resources, expertise, infrastructures, and technology to appropriately provide the contracted services.

Contracts

Contractual responsibilities are fundamental to protecting the bank's interests and to determining the level and type of risks the arrangement brings to the bank. Effective contracts detail each party's responsibilities, specify what activities the partner is permitted to conduct, and are updated as needed. They also address the risk factors identified during the bank's risk assessment and due diligence processes. Normally, bank counsel reviews the proposed contract. Examiners should look for evidence that the contracts are structured to provide for the sound operation of the program as well as compliance with the Associations' standards. The level of protection offered by the contract could be questionable if the bank does not require the partner to consistently abide by its provisions, which normally cover, among other items:

- Financial reporting.
- Covenants and parameters.
- Access to information.
- Materials and program control.
- Settlement reserves (collateral protection).
- Pricing.
- Ability to terminate contract.
- Audit.

Financial reporting:

As noted, the bank is liable for meeting the settlement requirement daily but may look to the partner to supply settlement monies. Further, many RAB contracts contain indemnification provisions, but indemnification by the partner is only as strong as the financial wherewithal of the partner. A partner's financial situation could quickly become stressed, even to the point where it may file bankruptcy or become insolvent, possibly resulting in the bank having to retain the receivables if it had not been doing so already. The bank could possibly also end up having to cover costs, such as if fines or penalties have been imposed, if the partner cannot properly reimburse the bank according to governing contract provisions. As such, contract verbiage normally requires the partner to provide reliable financial information, including balance sheet, earnings, cash flow, and contingent liability information. Examiners' attention should be directed to situations in which the frequency of financial statement submission and review is not commensurate with the risk posed by the program and/or the partner. Partners are typically required to submit financial statements at least quarterly and audited financial statements annually. For higher-risk programs or higher-risk partners, more frequent submission and review may be required. Examiners should see proof that the board of directors has assigned responsibility both for evaluating the financial information and for reporting the findings to the board (or a designated committee) to competent employees. Contracts that require proper financial reporting practices can help the bank mitigate the risk of operating under a contract and program that is not fully supported by the financial wherewithal of the partner.

Covenants and parameters:

Contracts normally contain financial covenants for the partner (such as capital requirements, liquidity expectations, and appropriate settlement reserve balances) as well as card portfolio parameters (such as growth restrictions and performance expectations). The partner is usually required to periodically report and certify compliance with the covenants and parameters, and the contract normally prescribes remedies in the event the covenants and/or parameters are violated. Examiners' attention should focus on situations in which management does not have access to and/or does not review reliable data to monitor and test compliance with the established covenants and parameters. Proper examiner attention should also be given to situations in which review of the partner's budgets and other projections is not occurring. Such reviews help to detect trends that might signal emerging problems with meeting the covenants and parameters in the future. Further, situations in which the partner has violated the covenants or parameters warrant review during the examination.

If the portfolio becomes stressed, the partner (if it holds the receivables) could experience reduced cash flows which may, in turn, affect its ability to meet settlement requirements and, thus, potentially require the bank to provide funding. Portfolio deterioration could lead to a weakening of the partner's overall financial condition since a substantial portion of its earnings performance usually depends on the portfolio. Further, portfolio deterioration could signal ineffective servicing and management of the portfolio by the partner or other contracted servicers and could eventually entice the partner to use overly aggressive collection or other questionable servicing techniques, which could exacerbate compliance and legal risks. If the partner does not maintain appropriate capital or other financial measures, it may not be able to make good on its indemnification obligations and may not be able to fund the receivables. Thus, if contracts do not establish financial covenants for the partner as well as portfolio performance parameters for the portfolio, the bank is left with the risk that the partner may not be able to properly perform its contracted obligations, such as purchasing receivables, paying the rental fee, and so forth.

Access to information:

To ensure that management can assess the partner's policies and practices for compliance with laws, rules, regulations, safe and sound business practices, and the Associations' rules, the contract ordinarily provides management with ready access to such policies and procedures. Examiners should confirm whether procedures have been established to notify the bank when service disruptions, security breaches, or other events pose risk to the bank or when the partner receives any consumer complaints or litigation notices related to the bank's program. If a contract does not provide for appropriate access to information, the bank may be at the risk of unknowingly being named in lawsuits or unknowingly having its customers' or other information breached. A lack of appropriate access could also inhibit the bank from promptly identifying any changes that the partner may have inappropriately made to its policies or operating procedures.

Materials and program control:

The agreements generally grant the bank pre-approval rights over all program materials (such as marketing materials and cardholder agreements). Pre-approval rights over plans to issue new products or to materially alter existing products are also typical control features. Further, review and approval of card fee structures prior to implementation is a critical function of bank management. The granting and exercise of all of these rights is necessary to ensure that the partner is not taking on inappropriate levels of risk that could ultimately impact the bank. Contracts that are structured to commit the bank to open or maintain any particular level or number of cards, accounts, or receivables could cause the bank or the partner to take on a greater level of risk than can be appropriately controlled.

Settlement exposure reserves (collateral protection):

The contract ordinarily requires the partner to provide some kind of security or protection against any settlement exposure that the bank might face if the partner is unable to settle through agreed-upon normal means. Normal means could include the partner wiring funds to the bank daily, an authorized debit of the partner's general operating account at the bank, or some other similar method. Security for the exposure if the partner is not able to settle via normal means frequently takes the form of a combination of two or more of the following options: a deposit account, a contingency reserve, a credit facility, or other mechanism. Some banks have required the partner to hold ten days of coverage in aggregate. In any case, the funds available to the bank should tie to a realistic, well-documented contingency plan. The portfolio's available credit (open-to-buy) position and trends in that position can point to potential future trends or worst-case exposures regarding settlement activity, and, thus, are important considerations for determining the adequacy of protection provided. Settlement exposure reserves frequently consist of two items:

- *A Deposit Account* - Many contracts call for the partner to provide for and maintain an adequate deposit to cover potential shortfalls that may occur in daily settlement. This deposit is normally separate from any operating accounts that the partner might have at the bank. Concern arises when the method for determining the necessary deposit amount has not been specified or controlled by the bank. The deposit is usually held at the bank, but, whatever the case, examiners should look for evidence that the bank has proper controls over the deposit, which may include a perfected first lien. The partner typically has outside financing, so without proper controls, the bank's lien could fall behind liens of the financier. The deposit is usually required to cover several days of settlement volume (for purchases, cash advances, and so forth). Some contracts call for coverage of three days of volume (when a contingency reserve or other reserve/protection source is also used). Each contract needs to be reviewed on a case-by-case basis in the context of the activities being conducted and of any additional support (or lack thereof) provided by other means. Effective calculations to determine the deposit consider items such as seasonal fluctuations, portfolio growth, and customer payment rates and are well-documented. Contract features also usually call for the partner to replenish the balance in the account within a very short period once the account is drawn on. Compliance with the deposit requirement is often included in covenant-monitoring reports. Failure by management to ensure the deposit is accurately calculated and sufficiently funded could lead to an inability to meet settlement needs without the bank providing funds.

- *A Contingency Reserve* - Contracts also frequently require the partner to fund and maintain (at the bank or at a third-party) an adequate contingency reserve (or similar instrument) for use if the partner is unable to fully replenish the deposit account. Like the deposit, a contingency reserve usually covers several days of settlement, although its coverage is ordinarily longer, such as around seven days. Contingency reserves also warrant review on a case-by-case basis. In lieu of a contingency reserve, some partners establish a credit facility to the benefit of the bank. An effective contingency reserve calculation (or credit facility or other instrument) considers items such as seasonal fluctuations, portfolio growth, and customer payment rates and is well-documented. If the contingency facility is at a third party, examiners should evaluate management's practices for periodically verifying the availability and liquidity of the funds. Contracts may call for the partner to replenish these secondary funding sources within a very short period in the event they are drawn on, although if the contingency reserves are being drawn on, the third party is likely under financial stress. Failure to ensure the availability of such funds or the adequacy of the required funding amount could lead to an inability to settle in the event the bank does not step forward with its own funds. Again, proper controls over the contingency instrument are critical.

Pricing:

Comprehensive contracts clearly depict the compensation structure, allow for periodic review and re-pricing of services, and identify which party is responsible for each expense incurred. If the partner or another entity holds the receivables, a bank essentially pays for perceived insulation from credit losses by foregoing higher compensation that would typically be associated with carrying the card portfolio on its books. Rather, in these cases, the partner typically retains most of the income generated by the portfolio and carries most of the expenses. Examiners should evaluate whether the bank's compensation is commensurate with the risks retained as well as with the costs incurred for monitoring and managing the arrangement.

Ineffective pricing structures could quickly erode the bank's profits. Therefore, examiners should determine whether, prior to entering into or re-negotiating a RAB contract, management performs detailed cost analyses of its expenses and tries to obtain information on comparable transactions. Because the responsibilities and card portfolios under each bank's arrangements are different, pricing structures are difficult to compare and vary from contract to contract. Some contracts specify tiered fee structures where the fee per account (the definition of account also varies from contract to contract) is reduced as the volume of accounts increases. For example, a contract might call for a dollar per account for the first 100,000 accounts, 75 cents per account for the next 200,000 accounts, and so forth[10]. Others use a flat monthly rate. Some contracts call for an upfront fee (or set-up fee) and/or establish a minimum fee per month. Whatever the case, examiners should expect pricing to adequately compensate the bank for its risks and costs.

Examiners should also expect that, throughout the life of the arrangement, management produces an income and cost statement for issuing RAB activities and properly budgets for its RAB activities. Effective statements display RAB fees or other related income received and all direct and indirect costs incurred. The bank might have to make a sizeable investment in the program to implement systems and personnel to appropriately run and monitor the program. And, it might not be a profitable venture for the bank if the RAB partner is unable to generate a sufficient volume of accounts or properly manage the program.

Examiners' attention should also be directed to situations in which management is not monitoring portfolio profitability, regardless of whether the bank holds the receivables. Portfolios that evidence deteriorating or negative earnings performance could signal improper management by the partner, existing or future stressed cash flows to the partner, or other impacts on the partner, all of which could potentially, albeit indirectly, result in safety and soundness risks to the bank.

Ability to terminate contract:

Comprehensive contracts address circumstances under which the bank can exit the agreement and set forth reasonable timeframes for such actions. For example, the bank normally has the ability to terminate the contract if the partner materially breaches the contract (usually after considering a reasonable cure opportunity). Timeframes for notification of intent to terminate should be commensurate with the risks and the reasons for termination. Contract language that requires the bank to incur substantial fees for terminating the contract for appropriate cause should be carefully analyzed. Contracts that do not provide the appropriate ability to terminate the contract leave the bank at the risk having to operate a program that could be unprofitable or that has substantial liquidity risks or other implications.

Audit:

The potential for serious or frequent violations and noncompliance exists when a bank's oversight program does not include appropriate audit features. As such, management normally retains the right to audit the partner (and its sub-contractors). Contract verbiage also normally requires the

[10] The fees cited here are for example purposes only and should not be construed to be typical or endorsed pricing.

partner to provide its applicable internal and external audit reports, including the findings of financial and procedural audits and the partner's responses thereto, to bank management for review. If a contract does not provide for appropriate audit access, it leaves the bank at risk of failing to timely identify concerns or problems with the program and its operations. As a result, the bank could become subject to elevated legal, compliance, or other risks.

Examiners should look for proof that the bank's internal audit program incorporates a comprehensive review of bank management's supervision and oversight of the RAB relationships and activities as well as a review of each entity's adherence to contract provisions. The bank's internal audit program is normally expected to confirm that policies, procedures, and materials for the RAB activities have been properly approved by bank management and comply with laws, rules, and regulations. It ordinarily includes periodic on-site inspections of the partner as well as requires the partner to respond to and address issues identified by the internal audits. Examiners should also assess bank management's practices for conducting its own audits of the partner's processes, especially when the partner has not provided for appropriate audits. Examiners should verify whether internal audits assess how the program complies with applicable laws, regulations, and guidance and whether the internal audits are well-documented and readily available. Regulatory scrutiny and risk management expectations for certain practices will be greater for higher-risk portfolios and segments as well as for higher-risk partners.

Contingency Planning

Examiners should also direct their attention to arrangements for which all parties involved, including the bank, purchasers, servicers, and other affected parties, do not have proper contingency plans in place. The review should incorporate an assessment of how management normally reviews those types of plans, particularly for entities providing material services. The bank's plans normally involve transferring the program to another entity, funding the program internally, or shutting down the card program if the contract is terminated. Examiners should substantiate whether contingency plans are written and board-approved, identify specific actions the bank will take, and include appropriate information such as contact information for the parties involved. Concern is normally elevated when the plans only include activation after default has occurred and do not consider actions to be taken to lessen risk exposure as soon as indications of potential default by the partner have become apparent. For cases in which securitizations are used either by the bank, partner, or third party as the funding mechanism for the receivables, contingency planning takes on added elements of complexity. For example, the plan then needs to address the impact of potential events on the ability to continue to sell assets to the trust.

Comprehensive, well-thought out plans consider exposures in worst-case scenarios, such as the existing full open-to-buy exposure combined with the maximum time necessary to close accounts, as well as potential, more likely scenarios, such as those that consider the ability to reduce credit lines and close problem accounts. Without a sufficient contingency plan, the bank could find itself in a strained liquidity position, similar to an early-amortizing securitization.

Ability to Cease Authorizations

The ability to cease authorizations on the cards if the partner materially breaches the agreement or does not maintain adequate deposits, contingency reserves, or other required collateral is crucial. Contracts and cardholder agreements normally allow the bank to stop authorizations. If management does not have such authority with the processor, problems could arise. If a bank cannot shut down or limit authorizations in a timely manner, it increases its funding risk and may ultimately end up taking on credit risk that it may not be able to control. Even with the authority to cease authorizations, problems could arise regarding the Association membership, impacting the bank's aggregate risk position.

Risk Measurement Systems

Risk measurement systems to operate, monitor, and control issuing-RAB activities are critical components to the successful operation of such activities. Examiners should assess reports that management regularly receives to determine whether those reports enable management to gauge, in a timely and comprehensive manner, the risk posed by RAB activities. Management normally receives and reviews key management reports no less than monthly. The reports commonly include items such as the number and dollar volume of accounts, delinquency and charge-off volumes, over-limit data, customer service metrics, sales volumes, payment volumes, profitability, and any other relevant metrics needed to appropriately gauge risk. Concerns arise when appropriate segmentation methods are not incorporated and when management is not closely monitoring the trend and volume of available credit (open-to-buy) positions. The level of available credit coupled with normal or expected account usage can be an indicator of future potential settlement requirements. Reports reviewed by management also normally include information for measuring the partner's performance against that required by the contract. If securitization activities are associated with RAB activities, examiners should require that reporting on the securitization facilities and performance is incorporated. Monitoring the securitized pool by both the bank and the partner is particularly important when the partner relies heavily on securitization for funding. The bank could have to fund settlement if an early amortization is triggered. In addition, adverse impacts on the partner's financial wherewithal from poor performance in the securitized receivables could impact the partner's ability to cover its other assigned expenses, such as fines or cardholder reimbursements.

The level of detail and frequency of reporting funneled to the board is contingent on the size and risk profile of the operation in relation to the overall operations of the bank and its capital base. However, board reporting normally occurs no less frequently than quarterly and more frequently in certain instances, such as if concerns with the partner or portfolio are identified, if the arrangements involve higher-risk activities such as subprime lending, if the card portfolios involved are sizable compared to the bank's asset base and capital level, or if it is a new activity.

PARTNER'S OTHER RELATIONSHIPS WITH THE BANK

Concerns normally arise when management has not considered lending or other relationships that it has with the partner when analyzing the bank's total risk exposure or when each applicable area of the bank involved with the partner does not inform the other(s) about any adverse change in the partner's credit quality. For example, a partner's failure to make a loan payment likely points to emerging credit quality problems that may affect the partner's ability to meet settlement requirements or to fund the deposit and/or contingency reserve.

Lending to a partner essentially creates a conflict of interest that could result in management failing to take appropriate action against the partner when problems arise. For example, management might not want to discontinue marketing the card program because such an action might jeopardize repayment of the bank's loan to the partner. When management continues with a problem relationship, it often exacerbates the problems and increases subsequent losses. Examiners should look for evidence that management fully understands the total risk exposure when lending to a partner and carefully manages any such relationships to ensure any losses are minimized.

CAPITAL

A bank must hold appropriate capital for all of its business lines, including issuing-RAB arrangements. Effective policies limit the bank's volume of issuing-RAB activity relative to the bank's capital, the bank's risk profile, and management's ability to monitor and control the risks. Examiners assess the records supporting the capital allocation for issuing-RAB activities.

Existing regulations do not assess a specific capital charge for the aspects of issuing-RAB activities that the bank may be carrying off balance sheet. But, regulators may require the bank to hold capital above the regulatory minimums when appropriate. In general, factors considered in determining the proper level of capital to hold include:

- Quality of the partner, including reputation, experience, and organizational culture.
- Bank's management expertise in the area of credit card operations and RABs.
- Quality of the RAB oversight program.
- Profitability of the RAB activities from both the bank's perspective and the portfolio's perspective.
- Any instances of breach of contract.
- Deterioration in the partner's financial condition.
- Type of program offered through the RAB arrangement because certain types of business, such as subprime lending, are inherently riskier.
- Portfolio balance as well as open-to-buy trends and exposures.
- Quality and reasonableness of contingency plans.
- Audit findings.
- Bank's risk profile, including the adequacy of capital to support its other business lines.

Some RAB banks that are not holding the receivables consider risk-weightings similar to those that would be in place if the receivables were still on the bank's books, adjusted for collateral or other protection available. Examiners should expect that any methodology used will be well-supported and thoroughly documented and tie to considerations such as, but not limited to, those identified in the prior bullet points.

ACCOUNTING

As discussed, issuing RAB arrangements can have various structures. In some cases, the bank may have even been retaining the receivables for quite some time and only later decided to move the receivables off its balance sheet. Examiners will normally look at management's documentation of the RAB structure(s), including bookkeeping entries used. Because the structures, operations, and bookkeeping entries for the arrangements vary based on the governing contracts, accounting consequences also vary. All it would take to bring a receivable within the scope of FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is for the receivable to be an asset of the bank for even a brief moment before being transferred to the partner or another party. In this case, management will need to determine whether or not the transfer of the receivables qualifies for sale accounting under FAS 140. To ensure all applicable accounting guidance (FAS 140 and otherwise) is followed, examiners would normally expect (and confirm) that management has consulted with the bank's accountants.

SUMMARY OF EXAMINATION GOALS – CREDIT CARD ISSUING RENT-A-BINS

Examiners must determine the extent of the bank's RAB activities as well as the level of risk that the activities pose to the bank. They must also determine whether the bank's capital level adequately covers the identified risk. Procedures for reviewing RAB arrangements are often similar to those procedures used to review other types of third-party arrangements. Examiners should review and assess:

- Applicable board and committee minutes, in coordination with the EIC.
- The bank's RAB policies to determine if they are comprehensive and that management is cognizant of the risks involved in such activities.

- Management's due diligence practices to determine whether this early line of defense against problematic relationships is effective.
- Staffing and resources to assess if the level is sufficient and qualifications are acceptable.
- The contract between the bank and the partner to determine if it is comprehensive and sufficiently limits the level of the risk that the bank assumes.
- Management's practices for testing and ensuring compliance with the contract to determine if emerging problems with the partner are promptly identified, thus allowing contract termination to be evoked timely when warranted.
- The marketing materials used for the program, including whether bank management exercises appropriate approval authority over such materials.
- The audit program to determine if it sufficiently encompasses issuing RAB activities.
- Deposit, contingency reserve, or other risk-mitigating funds/assets to determine if they are adequate, appropriately monitored, and readily available.
- Pricing structure and profitability data to assess whether fees received adequately compensate the bank and to identify any instances where portfolios might be unprofitable and, thus, appear to pose risk to both the partner and the bank.
- Contingency plans for thoroughness and reasonableness.
- Compliance with the AMG as well as any other applicable laws, regulations, or guidance.

In some cases, examiners should sample the partner's underwriting and other practices to compare them to established policies, laws, regulatory guidance, and other applicable devices. The use of or level of these types of review can be influenced by whether or not bank management is effectively reviewing and auditing such areas. If bank management is not properly reviewing the various areas, including underwriting and collections, then examination procedures will generally include expanded testing and review of the portfolio. Testing and portfolio review will also likely be expanded when higher-risk lending, such as subprime lending, or higher-risk partners are evident.

The following items might signal current or future elevated risk and warrant follow-up:

- Lack of appropriate RAB policies.
- Failure to appropriately monitor collateral protection, such as deposit and contingency reserve balances or other risk-mitigating devices.
- Unprofitable RAB operations.
- Unprofitable portfolios.
- Lawsuits or other complaints brought by cardholders.
- Compliance issues.
- Weak due diligence practices.
- Failure to properly monitor the partner's compliance with financial covenants and performance parameters.
- Failure to properly monitor performance of the portfolio.
- Failure to meet settlement requirements.
- Failure of the partner to provide open and timely communication with management.
- Weak understanding of the partner's activities and operations.
- Unfavorable correspondence from or to the Associations.

These lists are not exhaustive, and examiners must exercise discretion in determining the expanse and depth of review procedures to apply. If examiners identify significant concerns, they should expand procedures accordingly. In addition, examiners may limit the review as appropriate.

XV. LIQUIDITY

Liquidity is the ability to fund future asset growth and/or pay liabilities, in a timely manner, at a reasonable cost. Banks use a variety of funding strategies to support credit card portfolios. They often rely on a mixture of borrowings, brokered deposits, and securitization activities, and, as such, banks with substantial credit card holdings might exhibit a relatively high volatile liability dependency ratio. The advent of credit card securitizations dramatically expanded funding avenues for credit card portfolios.

Liquidity, especially for banks with large and/or higher-risk credit card portfolios, is sensitive to negative trends in credit and capital. Reputation risk also plays a critical role in the banks' ability to access funds readily and at reasonable terms. Deterioration in a bank's financial condition, management composition, or other relevant issues might result in reduced access to funding. A failure by bank staff responsible for managing liquidity to consider all information (such as downgrading by a rating agency) that could affect external perceptions of the bank's soundness may result in unanticipated and critical liquidity problems.

SIMILARITIES TO OTHER BANKS

Examiners should confirm whether the bank has board-approved written policies and procedures for day-to-day liquidity management as well as MIS adequate to measure, monitor, control and report liquidity risk. They should direct their attention to situations in which management does not, as part of a process for the ongoing measurement of funding requirements, analyze liquidity under various scenarios and/or periodically review underlying assumptions for such scenarios. Other situations requiring examiner attention include those in which the relationships with lenders, other liability holders, and market participants is not diversified and/or is not reviewed periodically to ensure adequate funding capacity exists. A failure by management to establish contingency funding plans (CFP), including strategies to handle emergency cash flow shortfalls and liquidity crises, normally also elevates concern.

Determining whether liquidity is adequate requires analysis of the current liquidity position, present and anticipated asset quality, present and future earnings capacity, historical funding requirements, anticipated future funding needs, and options for reducing funding needs or obtaining additional funds. Although liquidity risk dynamics vary according to a bank's funding market, balance sheet, and inter-corporate structure, the most common signs of possible liquidity problems include rising funding costs, requests for collateral, a rating downgrade, decreases in accessible credit lines, or reductions in the availability of long-term funding. The necessary sophistication of a bank's liquidity management process depends on its business activities and overall level of risk. Nevertheless and regardless of the bank's size and complexity, the principles of liquidity management are straightforward: to be well-managed, liquidity risk must be identified, measured, monitored, and controlled in a timely and comprehensive manner. Because concepts in this and the prior paragraph are similar to liquidity concepts for all banks (whether or not they have credit card activities), examiners should refer to the Liquidity chapter of the Risk Management Manual of Examination Policies for additional guidance.

FUNDS MANAGEMENT POLICIES

Well-developed funds management policies and practices provide for forward planning while taking into account any unique characteristics of the bank's credit card activities. They take into account the overall objective of the bank regarding asset and liability mix and desired earnings and also consider anticipated funding needs and the means available to meet those needs. Policy guidelines, in general, provide for:

- Establishment of an asset/liability committee, including identification of the committee's responsibilities, meeting intervals, and board reporting requirements.
- Periodic review of the bank's funding structure, including maturity distributions, interest rates paid, securitization activities, and alternative funding sources.
- A means of computing the cost of funds and ascertaining if it is within established objectives.
- Acceptable asset management parameters such as type and amount of short-term investments held, loan pricing, credit limits, and scheduled minimum payment rates.
- Suitable target ratios and/or parameters by which to gauge liquidity and volatile liability dependency.
- Periodic review to determine if the bank is within the stated ratios and parameters.

CONTINGENCY FUNDING PLAN

A liquidity crisis can occur without warning and leaves little time for strategy development. Further, projections of funding sources and uses are inherently imperfect. Examiners look at the liquidity policy to determine if it provides for a CFP that addresses alternate funding in the event initial funding projections are notably incorrect or a liquidity crisis arises. A comprehensive CFP is especially critical for banks with credit card activities that have a substantial or increasing reliance on alternative or potentially volatile funding sources, such securitizations.

A CFP is a cash flow projection and comprehensive plan that forecasts funding needs and funding sources under different market scenarios, including aggressive asset growth or rapid liability erosion. It should be updated on a regular basis and should represent management's best estimate of balance sheet changes that may result from a liquidity or credit event. A CFP helps management to monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources. Concerns arise when the intricacy and sophistication of the CFP is not commensurate with the bank's complexity and risk exposures, activities, products, and organizational structure. A robust list of features of an effective, comprehensive CFP is included in the Liquidity chapter of the Risk Management Manual of Examination Polices. A few of those characteristics include:

- Assessing the possible range of liquidity events that the bank might encounter.
- Examining the potential for erosion (magnitude and rate of outflow) by funding source under optimistic, pessimistic, and status quo scenarios.
- Considering potential liquidity risk posed by activities such as securitizations.
- Analyzing and making quantitative projections of all significant on- and off-balance sheet funds flows and associated effects.
- Establishing indicators that alert management to a predetermined level of potential risks.
- Identifying the adequacy of contingent funding sources, including the identification of any back-up facilities, any limiting conditions related to their use, the circumstances under which the bank might use them, and the anticipated sequences of use.
- Assessing the potential for triggering legal restrictions on access to brokered deposits under Prompt Corrective Action (PCA) standards and for affecting the liability structure.

CASH FLOWS FOR CREDIT CARD LENDING

Banks, particularly those in which credit card operations constitute a major part of their business, are exposed to liquidity risk from the credit card portfolio(s). Payments remitted by cardholders can provide a significant amount of cash flow. However, under the structure of retail payment systems, as discussed in the Merchant Processing chapter, card issuers fund cardholders' purchases and cash advances shortly after the transaction, regardless of when cardholders will remit their payments. Many consumers use their cards more at certain times, such as around gift-giving holidays. Further, credit cards generally do not have a fixed payment amount or fixed amortization period. Both seasonal demand and payment activity can substantially impact the bank's current and anticipated liquidity position. The liquidity position is also impacted by funding growth from new accounts generated and paying amounts due on liabilities. The Associations also might call upon the bank to provide collateral protection (such as a deposit pledge) in the event elevated risk is evident.

The UBPR details, among other things, the dollar amount and the interest rate on borrowed funds and brokered deposits, along with balance sheet and trend analysis. The following ratios are not a substitute for the quantitative analysis normally performed during examinations and involving review of the UBPR. Rather, these ratios supplement UBPR reviews and are intended to provide insight to liquidity facets about the credit card portfolio.

- *Usage Ratio* – The usage ratio equals total outstanding credit card receivables (including those receivables securitized and sold) divided by total outstanding credit card receivables (including those securitized and sold) and outstanding credit card commitments. It measures the percentage of aggregate credit card lines currently in use by cardholders and can aid management in evaluating consumer usage patterns and predicting the timing and amount of funding increases to outstanding credit card lines. A thorough understanding of the influence of over-limit volumes and practices is necessary to effectively analyze this ratio.
- *Unused Credit Card Commitments to Total Assets* – This ratio measures the amount of unused credit lines to total assets. Analyzed in conjunction with the usage rate, it determines the amount of funding needed to meet current credit card commitments. For some banks, unused commitments exceed on-balance sheet assets and capital by several multiples.
- *Payment Rate* – This ratio measures monthly collection of principal, interest, and fees and is stated as a percentage of outstanding credit card receivables. Cardholder's payments may be available to support unfunded credit card commitments and/or future growth. A decline in the payment rate might be the result of normal seasonal payment patterns or could signal potential liquidity challenges.

In addition to receiving cash flows from cardholder payments, the bank might use funding mechanisms such as securitizing credit card receivables, soliciting deposits, or establishing other borrowings from other banks and/or affiliates. This chapter focuses on inter-company relationships, brokered and other rate sensitive deposits, and securitization. Other types of funding sources are addressed in the Risk Management Manual of Examination Policies.

INTER-COMPANY RELATIONSHIPS

Some banks often rely on the parent company or other affiliates as a primary source of borrowed funds. Banks of larger parent companies frequently hold a minimal volume of liquid assets, choosing instead to borrow from affiliates as loan demand occurs. This practice not only reflects the parent company's desire to manage these specialized entities on a consolidated basis to take advantage of a lower cost of funds, but also enables the bank to maximize the significant level of higher-yielding credit card receivables supported on the balance sheet. Sometimes liquidity management decisions and planning functions are performed at the corporate level. As such, it can be misleading to limit the review to only the mix and maturity of the bank's balance sheet. Rather, examiners should obtain holding company-wide information for the consolidated organization's approach to liquidity management. That information should detail items such as where decisions are being made and what funding alternatives or options are available within the organization. Centralized planning and decision making is not a problem in and of itself. Nevertheless, examiners must determine whether the bank's board of directors is effectively exercising its legal responsibility to manage the bank's independent and unique affairs. Examiners must also closely inspect the support of the parent and affiliates. While the bank might be able to benefit by drawing on funds available from affiliates, there are other cases where the bank might be called upon to support and provide funding for its affiliates.

BROKERED AND RATE SENSITIVE DEPOSITS

While core deposits can be a key funding source, many banks, including those engaged in credit card lending, have experienced difficulty attracting core deposits or are prohibited from soliciting demand deposits depending on their legal structure, and, thus, may look to wholesale funding sources, including, but not limited to, brokered deposits and other rate-sensitive deposits. Brokered deposits usually exhibit highly-volatile characteristics and carry higher interest rates than other sources of funds. The use of brokered deposits is limited to well-capitalized depository banks and, with an appropriate waiver, to adequately capitalized banks. Certain other deposits are increasingly being attracted over the Internet, through listing services, or through special advertising programs that offer premium rates to potential depositors who have little or no other relationship with the bank. These deposits may not fall within the technical definition of a brokered deposit but, nevertheless, reflect similar features. They are high-yielding products that are 1) attractive to rate sensitive customers who do not have any other significant relationship with the bank, 2) potentially volatile and risky, and 3) deserving of management's attention.

Safety and soundness concerns arising from the acceptance of brokered deposits by adequately capitalized banks are ordinarily addressed by the conditions imposed in granting the waiver. The examiner should not only verify compliance with those conditions but should also assess whether any unanticipated problems are being created. The acceptance of brokered deposits by well-capitalized banks is subject to the same considerations and concerns applicable to any other type of special funding. The concerns relate to volume, availability, cost, volatility, and maturities. They also relate to how use of the funding fits into the bank's overall liability and liquidity management plans.

The proper use of these types of deposits should not be discouraged. However, customers who focus exclusively on yield (whether considered brokered or not) are highly rate sensitive and can be a volatile source of funding because if more attractive returns become available elsewhere, these depositors may rapidly transfer funds to other banks or investments. The departure of such deposits is especially concerning when these types of deposits have been used as a consistent and heavy funding source to support ill-planned or rapid expansion of credit card portfolios. Examiners are tasked with determining whether management is aware of the number, magnitude, and features of these types of deposits. Examiners should not wait for the PCA provisions of Part 325 to be triggered, or the viability of the bank to be in question, before raising relevant safety and soundness issues with regard to the use of these funding sources to support the bank's credit card lending activities.

SECURITIZATION

Securitizations are another form of rate- and credit-sensitive wholesale funding sources. Credit card securitizations are considered one of the most important financing innovations in the card industry's history, particularly for those entities where a majority of their business is credit card lending. Banks that securitize essentially transform a pool of assets (in this case, credit card receivables) into cash. The securitization typically involves the transfer or sale of on-balance sheet credit card receivables to a third party who then issues asset-backed securities that are sold to investors in the public debt market. The investors are paid from the cash flow generated by the transferred receivables.

Credit card securitization activities sometimes represent a majority of a bank's total funding and can be an effective funding method. Given adequate planning and an efficient process, it can create a more liquid balance sheet as well as leverage origination capacity. However, it can also be a volatile funding source and is closely tied to asset quality. Certain structures as well as excessive reliance on a single funding vehicle increase liquidity risk. Considerations and risks associated with using securitizations generally include:

- *Early amortization clauses* - Most securitizations have early amortization clauses to protect investors if the performance of the receivables does not meet the specified criteria. When early amortization is triggered, the issuing bank begins paying principal to bondholders earlier than originally scheduled and has to fund new receivables that would have otherwise been transferred to the trust. Examiner attention should be directed to situations in which the issuing bank is not monitoring deal performance to anticipate cash flow and funding ramifications that may stem from early amortization clauses. While issuers can seek an early amortization waiver, there is no guarantee that a waiver would be granted, and such waivers usually require the bank to provide compensation which could be quite costly.
- *Limitations of residual interests* - If the issuing bank has a concentration of residual interests, its overall cash flow might be dependent on the residual cash flows from the performance of the underlying receivables. If that performance is worse than projected, the bank's overall cash flow will be less than anticipated. In addition, retained residual interests typically do not have an active market and are not acceptable collateral to pledge for borrowings.
- *Marketplace reputation* - An issuer's marketplace reputation is crucial to its ability to generate cash from future securitizations. If this reputation is damaged, issuers might not be able to economically securitize assets and generate cash from future sales of credit card receivables to the trust. This is especially true for banks that are relatively new to the securitization market. Also, if the loans held-for-sale are funded with short-term funding, the bank will have to find alternative funding sources if it is not able to sell the receivables quickly.
- *Investor demands* - A bank can sell and operate in the asset-backed market at a reasonable cost only if it is able to meet investors' demands. Card portfolios comprised of higher-risk assets or that reflect unusual volatility can be difficult to securitize and/or sell. For example, investors often quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. Further, developments such as a rise in delinquencies or charge-offs could have significant implications. For example, the securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on a bank's subsequent issues. Or, similar deterioration may result in the bank having to increase enhancements (such as a spread account).
- *Time to implement* - A first-time securitization deal may take a few months (and maybe longer) to complete. Subsequent deals usually process quicker, and sometimes may take less than a month. Nonetheless, securitization still takes time to complete, and concerns would normally arise when that timing has not been factored into the bank's liquidity plans. Other credit facilities or funding sources (such as a **warehouse facility**) are usually needed for flexibility during deal negotiations.
- *Capital allocation* - Banks originating credit card receivables specifically for securitization sometimes depend too much on securitization markets to absorb new asset-backed security issues and might only allocate just enough capital to support a flow of assets to the securitization market. This strategy could cause funding difficulties if circumstances were to force the bank to hold assets on its books.

There are many ways management mitigates some of the risks associated with credit card securitizations. For example, they correlate maturities of securitizations with overall planned balance sheet growth and put adequate monitoring systems in place to alert it well in advance of an approaching trigger. An advance warning mechanism allows management time to consider preventative actions as well as factor the maturity and potential funding needs of the receivables into shorter-term liquidity planning. A failure by management to consider the liquidity implications of securitizations in the bank's day-to-day liquidity management and the CFP is cause for concern. Examiners should look for evidence that management has analyzed each actual or contemplated securitization for its impact on liquidity both as an individual transaction and as a component of the aggregate funds position. Discussion about credit card securitization activities, including its cash flows, is housed in the Risk Management Credit Card Securitization Manual.

ASSET MANAGEMENT

Typically, asset management of commercial banks requires managing the bank's asset structure through either the sale or planned run-off of readily marketable assets specifically set aside to meet liquidity needs. While this strategy is not necessarily uncommon to banks with credit card activities, these banks might have a limited amount of liquid assets because of their access to outside funding sources and their ability to devise other strategies such as setting cardholder minimum payment rates at higher levels and establishing lowering credit limits on new accounts. Although simplistic, these strategies allow management the possibility to increase cash inflows while limiting the potential for loan growth.

Banks can also sell their credit card portfolios. The value of a portfolio is predicated on several factors, including, but not limited to, yields, charge-off rates, delinquencies, and market conditions. Changes in any of the factors could dramatically affect the portfolio's valuation. Further, management cannot control certain conditions (market and economic) that exist at the time a portfolio sale would occur. These dynamics can make it difficult to determine whether a portfolio sale would sufficiently cover the bank's obligations without adversely impacting capital and earnings.

FUNDING CONCENTRATIONS

A failure by management to carefully consider potential funding concentrations when selecting liquidity strategies may result in an elevated risk profile. For example, if the provider could not provide additional funds or if it takes action to reduce the bank's access to funds, the bank may be left with few funding alternatives. There are no designated amounts or sizes that define a liability concentration. Rather, it is an amount that, if withdrawn alone or at the same time as a few other large accounts, would cause the bank to significantly change its day-to-day funding strategy. Concentrations most often are very credit sensitive, although collateralization may provide some mitigation depending on its quality and reliability. Examiners normally look to see whether management reviews reports on large funds providers and whether the reports properly consolidate funding obtained from a single provider or a closely-related group of providers.

RENT-A-BINS

Off-balance sheet liquidity risk often exists for issuing Rent-a-BIN (RAB) arrangements because the bank would be required to fund receivables in the event the partner is unable to fund (purchase) the receivables in a timely manner. Further, the bank may be required to post collateral to support programs evidencing elevated risk (even if the receivables are not held by the bank), and the collateral would not then be available for other uses. Issuing RABs are discussed in the Credit Card Issuing Rent-a-BINs chapter.

SUMMARY OF EXAMINATION GOALS - LIQUIDITY

Examiners are tasked with determining whether the bank will be able to support anticipated asset growth and meet its payment obligations in a timely manner and at a reasonable cost. In general, examiners' activities usually involve:

- Reviewing board and applicable committee minutes (in coordination with the EIC).
- Determining and understanding the bank's funding strategies.
- Identifying funding sources, frequency of use, current use, and remaining capacity. When securitization is used, examiners should reference the Risk Management Credit Card Securitization Manual.
- Evaluating the stability and diversification of borrowings or market instruments, including assessing whether any funding concentrations exist.
- Inspecting the composition, maturity distribution, and stability of deposits, including brokered deposits and other rate-sensitive deposits.
- Determining the bank's asset management strategy.
- Investigating the adequacy of liquidity policies and the CFP.
- Reviewing management's analytical analysis of the bank's liquidity.
- Considering the volume of and trends in unfunded commitments and cardholder payments.
- Determining whether management understands seasonal demands and whether those demands can be funded reasonably.
- Analyzing liquidity risks posed by issuing Rent-a-BIN arrangements.

The following items might signal current or future elevated risk and warrant follow-up:

- Ineffective management or oversight of the liquidity position.
- The absence of adequate policy limitations and guidelines.
- Aggressive growth strategies.
- Inadequate internal audit coverage.
- Inadequate information systems and/or reporting of the liquidity position.
- Use of rate sensitive funds not in keeping with the bank's strategy.
- Inadequate consideration of risk, with the focus exclusively on rates and yields.
- Significant shifts in the type of funding sources used.
- Involuntary reduction of available funding lines.
- High delinquency rates or deterioration in other card portfolio quality indicators.
- Deterioration in the general financial condition of the bank.
- Rating downgrades for the bank or its securitization activities.

These lists are not exhaustive, and examiners must exercise discretion in determining the expanse and depth of examination procedures to apply. If examiners identify significant concerns, they should expand procedures accordingly.

XVI. EARNINGS

Earnings help safeguard against the risks of engaging in the credit card business and represent the first line of defense against capital depletion. Credit card activities continue to offer banks substantial opportunities for profit. Although prosperity from credit card lending has fluctuated over the years, returns on credit cards have remained higher than returns on most other commercial banking activities.

On a bank-by-bank basis, credit card earnings vary widely based on a number of factors, such as management's expertise, products offered, the bank's risk appetite, cyclical or seasonal trends in the economy and consumer behaviors, and other happenings in the economic and competitive environments (natural disasters, regulatory or legislative issues, and so forth). Viability for banks that operate in highly competitive industries like the credit card industry is predicated on continual adaptation to the changing conditions. That requires an understanding of how various factors are affecting the bank and appropriate actions to address the impacts. Further, profit margins for credit cards can sometimes be illusory, such as if they are based on a high volume of penalty fees that have yet to be collected, on inappropriately reported gains on sales of receivables, or on unsustainable events. As such, thorough analysis of the financial performance of the credit card operations is necessary.

As is the case with other commercial banks, overall profitability for a bank conducting credit card activities should consider return on average assets (ROA), net interest margin (NIM), noninterest income as a percentage of average assets, and noninterest expense as a percentage of average assets. Examiners should also closely inspect the various income and expense categories to evaluate which subcomponents contribute positively or negatively to the bank's operations, to what degree those subcomponents contribute, and how the subcomponents are expected to impact future earnings performance. To evaluate earnings, particularly income categories, the examiner must consider, among several other factors, whether pricing of the credit card product(s) is effective.

PRICING

Pricing is a key determinant of the profitability of a credit card program. Interest rates charged on the credit cards are usually a prominent pricing component. Card issuers now offer a broad range of card plans with various rates (depending on credit risk and consumer-usage patterns) as well as differing interest charge calculation methods. Many issuers have also moved to variable-rate pricing that ties movements in the cards' interest rates to a specified index that moves with market rates. As such, interest rates on credit cards in general have become more responsive to issuers' costs of funds. But, many issuers have also attempted to gain or maintain market share by offering low, introductory rates (or teaser rates) to new customers and/or for balance transfers. Tightened margins from high quality borrowers, in part due to those practices, have led many banks to expand offerings to subprime borrowers. Interest rates on subprime credit cards are generally higher than those for prime credit cards, but with other pricing tools available to banks, this is not always the case.

Card pricing includes a variety of elements to supplement the interest rate charged. Pricing structures are increasingly comprised of a myriad of upfront, punitive, and other fees that play a pivotal role in a program's profitability. Fees within the industry include, but are not limited to:

- Annual fees.
- Cash advance fees.
- Over-limit fees.
- Late fees.

- Balance transfer fees.
- Acceptance fees.
- Program fees.
- Account set-up fees.
- Maintenance fees.
- Participation fees.
- Processing fees.

This list is not exhaustive but effectively illustrates the multifaceted fee structures that are in place in the current market. Ordinarily, subprime credit card accounts exhibit a much higher level of upfront fees than do prime accounts. Pricing structures of the credit card products and names for similar fees vary between banks. Fee sizes have grown significantly over time but, increases to many of the fees are slowing. FAS 91 addresses accounting for certain fees and is discussed under a separate heading later in this chapter.

Fee waivers are sometimes used as an account retention tool, and, as mentioned in the Portfolio Management chapter, are sometimes used as a collection tool. The volume of fees forgiven could substantially impact earnings performance, particularly on a short-term basis. However, if the fees were charged and ultimately not collected, true earnings performance would not be affected to a significant degree on a long-term basis, assuming appropriate accounting occurred.

Changes in fee assessment and waiver practices, possibly due to a bank's implementation of the AMG, might also impact earnings. The changes generally result in lower fee incidents, all other things remaining equal. A higher frequency of waived fees as well as reduced levels of over-limit and delinquent accounts results in fewer fees recorded than would have been recorded with past practices. But, if the fees that would have been assessed per past practices would ultimately not have been collected, long-term earnings performance would not be substantially affected, assuming appropriate accounting occurred.

INTEREST AND FEE INCOME

Interest and fee income includes, but may not be limited to, interest income on credit card balances reported as loans, loan origination and commitment fees, and past-due charges. Income from seller's and residual interests retained in a securitization is also reported in the interest and fee income category. Contribution of the category to the ROA typically depends on several factors, including:

- Each vintage of a product offering has inherently unique characteristics such as stated finance charges and fees. Management normally prepares profit analyses for the total portfolio and for significant portfolio segments to determine contribution to interest income.
- The greater the volume of **convenience users**, the lower the yield produced on the portfolio. Convenience users differ from **revolvers** in that convenience users pay outstanding charges in full for each billing. Banks generally benefit from convenience users due to interchange and/or annual fees, which are discussed in the Noninterest Income section of this chapter.
- The number of collections days in a month is a factor of management's posting procedures (posting collections on weekends versus business days only) and the number of days in the month. Banks that do not post collections on weekends typically pose more yield volatility.
- The length of the **grace period** can also influence the amount of interest consumers pay when they use credit cards to generate revolving credit.

NONINTEREST INCOME

Noninterest income includes, but is not limited to, interchange, annual fees and other periodic fees. Interchange represents the fee extracted from the merchant **discount rate** by the accepting entity and paid to the issuer. It is set by the Associations and normally is expressed as a certain percentage of the consumer's transaction plus a per-transaction fee ($). An annual fee is charged to the cardholder each year for use of the card and is typically assessed based on the perceived value of the credit card and any associated enhancements. According to Call Report instructions, fees that are periodically assessed are to be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card.

Certain income streams related to securitization activities also fold into noninterest income. The bank might report net servicing fees from servicing credit cards held by others (such as those that might be securitized). It might also report securitization-related earnings in the form of income streams associated with administrative support, liquidity support, **credit enhancement** support, or other support functions provided in an agent capacity. Additional impacts on earnings from credit card securitizations are discussed later in this section, and a full discussion of credit card securitization activities is housed in the Risk Management Credit Card Securitization Manual.

Noninterest income also includes charges to merchants for the bank's handling of credit card sales when the bank does not carry the related loan accounts on its books. Examiners should refer to the Merchant Processing chapter when reviewing merchant and acquiring programs.

INTEREST EXPENSE

The cost of funds is normally a major interest expense item and includes costs for items such as borrowings and brokered deposits. Funding costs vary depending on the parent's financial strength; the bank's size, condition, and reputation; and availability to the market. The UBPR details cost data for funding sources.

NONINTEREST EXPENSE

Noninterest expense includes, but is not limited to:

- Credit card processing costs.
- Marketing expenses.
- Collection costs.
- Credit card servicing costs.
- Fraud investigation costs and charge-offs
- Outsourcing costs.
- Litigation costs.

Noninterest expenses vary significantly, and the variations are normally related to the type of product offered, marketing techniques, collection procedures, technology employed by the processing department, and account or transaction volume. Direct mail solicitations remain a primary marketing channel and can result in a sizable amount of postage and mailing expenses. Printing expenses can be sizable due to the high volume of accounts. Overhead expenses tend to be higher in credit card operations than in other areas of a bank. The small size of individual accounts, the high transactional volume, and the myriad of servicing needs create higher costs per account. Because in-house data processing and collection costs are expensive, many banks contract these activities to third-party vendors.

FAS 91

Issuers often charge fees in connection with issuing or renewing a credit card and also incur certain credit card origination costs. Accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing loans are set forth in FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. The statement provides guidance on when and how loan origination and commitment fees and origination costs should be recognized in earnings. It applies to all types of loans, including credit card loans, and to all types of lenders. While a synopsis of the statement is offered here, examiners should refer to the pronouncement for full guidance and should look to accounting specialists when necessary.

FAS 91 is usually applied to individual loan contracts but aggregation of similar loans for purposes of recognizing net fees or costs and purchase premiums or discounts is permitted under certain circumstances as specified in the statement or if the result does not differ materially from the amount that would have been recognized on a loan-by-loan basis.

In general, FAS 91 specifies that:

- Origination fees should be recognized over the life of the loan as an adjustment of yield.
- Certain direct origination costs should be recognized over the life of the loan as a reduction of the yield.
- Most loan commitment fees should be deferred, except for specified exceptions.
- Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans are recognized as an adjustment of yield, generally by the interest method based on the contractual term of the loan.

With respect to credit cards, FAS 91 treats available lines of credit under credit card arrangements as loan commitments and views credit card fees as being loan commitment fees. However, it recognizes that credit card fees generally cover many services to cardholders. Therefore, FAS 91 requires fees that are periodically charged to cardholders to be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card.

The FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases: Questions and Answers*, discusses certain facets of the statement. Its answers for questions 31, 32, and 56 relate to credit card lending. Question 31 discusses the period and method that should be used to amortize costs associated with credit card originations. Question 32 talks about solicitation efforts that involve a third party. Question 56 discusses the amortization period if borrowings are repaid and the revolver is unused for a period of time. Examiners should refer to the implementation guide, which can be accessed through the accounting section of the FDIC's internal website, for details. They may also reference FASB Emerging Issues Task Force (EITF) Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*, and EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions*. EITF Issue No. 88-20, *Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio* addresses the amortization of a premium paid when an entity buys a credit card portfolio. The Purchased Portfolios and Relationships chapter discusses portfolio purchases.

COMPETITION

Banks sometimes compete with one another for market share by offering low introductory rates and **convenience checks**. Teaser rates affect the offering bank by stimulating asset growth. Profitability is sacrificed on a per asset basis but, more dollars of overall net operating income are earned. As a result, ROA may tighten, but ROE normally increases by additional dollars earned, assuming no other changes to equity capital. Banks holding accounts on which balances are transferred to other banks via use of convenience checks may realize lower revolving balances or increased attrition.

The Associations periodically provide banks with cost studies and industry data which can be helpful in evaluating the bank's performance within the industry. The FFIEC's website contains a link to a customized UBPR for CCSBs, and the bank's UBPR may also reflect data from one of the three peer CCSB subgroups (as discussed in the CCSB section of the Identification of Involvement in Credit Card Activities chapter). All of these types of reports can be valuable tools for assessing profitability, but failure to consider differences such as products offered and risk appetites can invalidate the review's results.

GROWTH ENVIRONMENT

Earnings performance can be difficult to judge in a high-growth environment due to the uneven stream of cash flows. Loss rates do not stabilize until several months after origination. Further, the timing of costs is often not consistent with revenues. After the initial acquisition cost there is a period of revenues with minimal credit losses, and, later, a period of increasing credit losses.

MANAGEMENT REPORTING, BUDGETING, AND STRATEGIC PLANNING

Examiners should assess whether management has established adequate MIS that detail income and expense items and provide an accurate representation of profitability. They should consider whether reports are flexible while allowing management to make appropriate and effective future strategic decisions. In general, reports normally consider:

- The portions of the portfolio that have fixed- and variable-rate pricing.
- The re-pricing frequency on variable-rate products.
- Significant segments, and which of those segments contribute positively or negatively to profitability.
- Trends of income and expense items.
- The effects recent trends have on current earnings and may have on future earnings.

Furthermore, for banks to remain competitive, it is increasingly necessary for management to be able to measure and monitor profit levels at the individual-account level and possibly for each campaign. For example, an individual-account level understanding can be especially critical in establishing effective retention practices. Monitoring costs and profitability of each campaign can identify its success or failure, thus allowing management to respond accordingly.

The profit analysis portion of the examination normally incorporates the review of the bank's strategic plan as well as its budgets. Strategic plans vary between banks based on risk tolerance, growth objectives, and funding strategies. A failure of the bank's strategic plans and budgets to be based on realistic objectives and attainability given the market environment could result in substantial differences, potentially adverse, between plans and actual results. If budgets vary significantly from actual results or the strategic plan, or if the strategic plan contains material changes from past practices, examiners should discuss the causes or reasons for the variations with management.

CAPITAL SUPPORT

The evaluation of earnings should also consider the ability of earnings to appropriately support capital. The bank's flexibility to reduce dividend payments should be considered when analyzing the impact of dividends upon earnings. High earnings retention may or may not be necessary, depending on the situation. If growth is low, profits high, and capital strong, a relatively high dividend payout may be acceptable. But, if growth is rapid, profits are low, and capital is weak, any high dividend payout might be standing in the way of retaining needed capital.

QUALITY OF EARNINGS

Earnings quality is defined as the ability to continue to realize (or sustain) favorable earnings performance and is often closely linked to asset quality. A bank might register impressive profitability ratios and high volumes of income by assuming an unacceptable degree of risk. Short-term earnings might be boosted by seeking higher rates for the higher credit risk but ultimately, earnings might suffer if losses in these higher-risk assets are recognized. Poor portfolio quality could necessitate increasing provisions for loan losses as well as result in elevated account servicing costs and reduced fee income. Consequently, portfolio quality must be considered when determining earnings quality. And, similar to analysis at traditional commercial banks, examiners should be alert for short-term earnings performance that is enhanced by extraordinary items and/or tax strategies.

KEY FINANCIAL INDICES CONCERNING PROFITABILITY

The following indices are helpful in gauging earnings performance, including that of credit card operations:

- *Yield on Total Loans and Leases* – This ratio measures the amount of interest and fees on loans as a percentage of average total loans. The UBPR also contains a line item specific to yield on the credit card portfolio, which is especially helpful when the bank's loan portfolio contains a notable volume of other types of credits.
- *Net Losses to Average Total Loans* – This ratio measures the amount of gross charge-offs, less gross recoveries, as a percentage of average total loans. The UBPR also contains a line item specific to losses attributed to credit card plans. This line item is again particularly helpful when the bank's loan portfolio contains a notable volume of other types of credit.
- *Percentage of Variable-Rate Loans to Total Loans, and Percentage of Fixed-Rate Loans to Total* Loans – These ratios measure the percentages of variable-rate and fixed-rate loans and are useful in assessing the bank's sensitivity to market risk.
- *Operating Expenses to Active Accounts* – This ratio measures the percentage of operating expenses used to maintain an active account relationship.

The usage ratio and the payment rate are also helpful and are discussed in the Liquidity chapter.

CONSIDERATION OF SECURITIZATIONS AND CARD-ISSUING RENT-A-BINS

In credit card securitizations, credit card receivables are taken off the bank's balance sheet while a residual income stream generated from the receivables continues to flow to the bank. The earnings performance of the portfolio will be overstated if the profitability analysis only considers on-book receivables but all credit card related income streams. Securitization changes the bank's income composition such that the result is less interest income and more fee-based income. For example, if a bank retains servicing, it receives servicing fees. However, in that case, personnel expenses will likely be high relative to the bank's on-book asset volume.

Securitization does not change the true operating performance of the credit card portfolio. When a bank is involved with securitizations, examiners should determine whether management considers **total assets under management** in its profitability analyses. Supplemental earnings indices used to incorporate consideration of securitization activities may include:

- *Return on **<u>Estimated Managed Assets</u>*** – This ratio measures the return on assets by adding all receivables securitized to the average assets and represents overall profitability on a managed basis.
- *Average Cost of Securitization versus Average Balance Sheet Funding Cost* – This ratio measures the off-balance sheet funding cost in relation to the balance-sheet funding cost.
- *Excess Finance Charges to Estimated Average Securitized Assets* – This ratio measures the profitability of the bank's securitized receivables after all obligations of the **<u>Qualified Special Purpose Entity</u>** have been met in relation to estimated average managed assets.
- *Excess Finance Charges to Noninterest Income* – This ratio measures the amount of income from securitization activities in relation to total noninterest income.

Examiners should refer to the Risk Management Credit Card Securitization Manual for additional information on securitizations, including a discussion on excess finance charges.

Issuing Rent-a-BINs can create similar changes to the income statement. Since most or all of the receivables are usually not held by the bank, interest income on those balances usually does not go to the bank. However, a noninterest income stream flows to the bank via the fee paid from the partner to the bank. The bank might also earn servicing or other revenues, depending on the contracts. The Credit Card Issuing Rent-a-BINs chapter discusses income and cost statement expectations when a bank operates a Rent-a-BIN program. Situations in which management is not reviewing the financial performance of the card portfolio(s) as well as the financial statements of the partner warrant examiner attention as do situations in which management is not preparing and reviewing bank-only analyses for income received and costs incurred for operating the Rent-a-BIN program.

SUMMARY OF EXAMINATION GOALS - EARNINGS

Examiners assess the quantity, quality, and sustainability of earnings from credit card operations and consider the impact of those earnings on the quantity, quality, and sustainability of overall bank earnings. Tools available to assist the examiner include, but are not limited to, the UBPR, the Call Report (including its instructions and glossary), the bank's financial statements and subsidiary ledgers, and management's analytical reports. An effective analysis of earnings generally includes:

- Evaluating the quality and depth of management and staff of the finance department (or of the individuals designated to oversee earnings if there is not a finance department) based upon size and complexity of the issuer.
- Reviewing income and expense categories to evaluate which components contribute positively or negatively to the bank's operations.
- Determining the type and level of fee-based income received and reviewing trends.
- Considering the extent to which fees are a recurring and viable source of revenue.
- Verifying that the bank appropriately recognizes uncollectible accrued interest and fees through the ALLL or other appropriate allowance-type mechanisms.
- Determining how teaser rates and convenience checks play into the bank's marketing and promotional campaigns and what effect these practices have on earnings.
- Determining if management monitors the amount of convenience users in relation to revolvers and what effects convenience users are having on earnings.
- Determining if the bank's accounting system is capable of generating profit data by product, segment, channel, and account.
- Analyzing whether management adequately monitors and assesses profitability on the portfolio and each significant segment and identifying whether reports are useful and accurate.

- Reviewing the pricing matrix by product.
- Assessing the adequacy of a bank's processes for pricing products as well as projecting and tracking profitability of each product, including determining whether all costs associated with the loans are considered.
- Reviewing pricing models, if applicable.
- Reviewing major assumptions used in the pricing method and considering differences in assumptions by product and channel.
- Determining whether pricing is driven by risk, capital, or another allocation method or hurdle.
- Determining how much pricing is driven by competition.
- Determining whether the pricing method incorporates a realistic break-even analysis, and whether the analysis reflects the true costs of attrition and reductions (prepayment).
- Evaluating budgets, including deciding whether assumptions are reasonable and whether the budgets are consistent with strategic plans.
- Reviewing the most-recent fiscal year-end and current year-to-date financial information and comparing results to budgets and forecasts to determine significant variances.
- Determining the impact of any contingent liabilities from rebate reserves and any associated impact on earnings.
- Considering findings from the allowance adequacy assessment and whether additional provisions are necessary to adequately fund allowances.
- Determining, quantitatively, profitability on estimated average managed assets when the bank uses securitization.
- Reviewing accounting practices.

XVII. SENSITIVITY TO MARKET RISK

Sensitivity to market risk is generally described as the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect earnings and/or capital. Market risk for a bank involved in credit card lending frequently reflects capital and earnings exposures that stem from changes in interest rates. These lenders sometimes exhibit rapid loan growth, a lessening or low reliance on core deposits, or high volumes of residual interests in credit card securitizations, any of which often signal potential elevation of the interest rate risk (IRR) profile. Management is responsible for understanding the nature and level of IRR being taken by the bank, including from credit card lending activities, and how that risk fits within the bank's overall business strategies. The adequacy and effectiveness of the IRR management process and the level of IRR exposure are also critical factors in evaluating capital and earnings.

A well-managed bank considers both earnings and economic perspectives when assessing the full scope of IRR exposure. Changes in interest rates affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. The impact on earnings is important because reduced earnings or outright losses can adversely affect a bank's liquidity and capital adequacy.

Changes in interest rates also affect the underlying economic value of the bank's assets, liabilities, and off-balance sheet instruments because the present value of future cash flows and in some cases, the cash flows themselves, change when interest rates change. The combined effect of the changes to these present values reflects the change in the bank's underlying economic value. An adverse change in the economic value of equity can signal future earnings and capital problems. It can also affect the liquidity of assets because the cost of selling depreciated assets to meet liquidity needs or to access market-based funding may be prohibitive.

JOINT AGENCY POLICY STATEMENT ON INTEREST RATE RISK

In 1996, the *Joint Agency Policy Statement on Interest Rate Risk* (IRR Policy Statement) became effective. All banks, including those engaged in credit card activities, are expected to follow its guidelines. The IRR Policy Statement identifies key elements of sound interest rate risk management and describes prudent principles and practices for each of the key elements. It emphasizes the importance of adequate management oversight and of a comprehensive risk management process. It also describes the critical factors affecting the evaluation of a bank's interest rate risk when making a determination of capital adequacy. Each bank is unique, and bank management is responsible for identifying the significant IRR risks in its bank and developing a methodology which adequately captures the risks. Some potential considerations specific to credit cards are discussed in the remainder of this chapter but are not exhaustive.

IRR CONSIDERATIONS SPECIFIC TO CREDIT CARD LENDING

As stated in the IRR Policy Statement, measurement systems for evaluating the effect of changing rates on earnings may focus on either net interest income or net income. Banks with significant non-interest income that is sensitive to changing rates generally focus special attention on net income whereas banks with the preponderance of income derived from interest-sensitive credit card yields net of interest-sensitive funding costs generally focus on net interest income. Increased use of variable-rate pricing on credit cards and the wide spreads usually realized by the card programs typically provide some flexibility in absorbing risk.

Interest income derived from credit card portfolios is sensitive to changes in market interest rates. Management normally considers the variety of pricing programs offered and the impact of competition in its IRR analysis. Intense competition often leads to pricing campaigns that are aimed at attaining market share and that can create margin compression.

Interest expenses borne by banks to fund credit card portfolios are also sensitive to changes in interest rates. As discussed in the Liquidity chapter, funding for credit card portfolios frequently takes the form of wholesale funds rather than core deposits. Typically, wholesale funds, such as brokered deposits and borrowings, are very sensitive to interest rates.

Interest rate mismatches occur when credit card receivables, whether fixed or variable, mature or re-price at different intervals than the funding liabilities. This situation often results from the bank's interest-bearing liabilities, such as borrowed funds, re-pricing daily or weekly, while its credit card receivables re-price less frequently. Interest rate risk mismatches may be exacerbated by management's hesitation to raise interest rates on fixed-rate credit card receivables[11], which in theory can be changed, but seldom are. The effect of mismatched funding in re-pricing positions can have a dramatic effect on a bank's interest rate margin, particularly in shorter-term positions.

Exhibit C illustrates how mismatch risk manifests itself as a reduction of net interest income and the ROA. It assumes that the average funding cost, tied an index, rises 50 basis points from 8.0 percent in month one to 8.5 percent in month two and that the average monthly interest rate on the credit card portfolio remains fixed at 14.4 percent. If a bank had $1 billion in credit card receivables, net interest income would have declined in the second month by $400,000 ([0.53 percent-0.49 percent] x $1 billion) as a result of mismatch mix.

Exhibit C

	Month 1	*Month 2*
INTEREST INCOME:		
Average Monthly Interest Rate Charged to Cardholders (14.4 % / 12)	1.20 %	1.20 %
INTEREST EXPENSE:		
Average Monthly Interest Rate on Funding		
Month 1 = (8.0 % / 12)	0.67 %	
Month 2 = (8.5 % / 12)		0.71 %
NET INTEREST INCOME:	0.53 %	0.49 %
NONINTEREST INCOME:		
Average Monthly Fees (1.8 % / 12)	0.15 %	0.15 %
NONINTEREST EXPENSE:		
Average Monthly Charge-Off Rate (4.0 % / 12)	0.33 %	0.33 %
Average Monthly Servicing Fee (2.0 % / 12)	0.17 %	0.17 %
NET INCOME ON CREDIT CARD PORTFOLIO	0.18 %	0.14 %

Basis risk occurs when the re-pricing of floating-rate credit card receivables is tied to a different index than the funding liabilities. As an example, basis risk could occur if funding costs are based on 3-month LIBOR but variable-rate pricing structures on the card accounts are tied to a different market rate that may not move with LIBOR.

Non-interest income and expenses for credit card activities can also be sensitive to interest rate changes. Depending on the fee type, credit card fees can be thought of as adjustments to the yield on the card portfolio or as non-interest income. Thus, changes in cardholder behavioral patterns and management's fee waiver practices will affect net income, and potentially net

[11] A fixed interest rate can only change if the bank properly notifies cardholders via an amended cardholder agreement.

interest income. Cardholder behavior is discussed next and can be substantially influenced by changes in interest rates, even if the rate change is not specific to cardholders' credit card accounts with the bank.

Consumer Behavior

As spoken to in the IRR Policy Statement, assumptions about customer behavior must be reasonable and consistent with each rate scenario evaluated. Although it may not be an interest rate risk exposure in the traditional sense, changes in cardholders' behavior due to interest rate changes could have a detrimental impact on asset quality and earnings, especially when the cardholder base is largely subprime. With banks expected to structure minimum payments to reasonably amortize the debt, rises in interest rates could increase the required minimum payment for cardholders when the account is variable-rate in nature. In addition, a rise in interest rates could tighten the cardholders' ability to repay all debts (whether at the bank or otherwise). As the rates rise, cardholders may be inclined to re-prioritize payments. If a cardholder has a fixed-rate card account and his or her other variable-rate debt begins to carry higher interest rates, the cardholder might prioritize payments to favor the variable-rate debt. Conversely, as interest rates fall, if a cardholder has a variable-rate card account but other debt at a higher, fixed-rate, the customer may prioritize to pay off the higher, fixed-rate debt first. Consumer behaviors such as these are difficult to measure and could be exacerbated because consumers frequently place less emphasis on repaying unsecured debts than on home and automobile debt.

Minimum Payment Considerations

Depending on the minimum payment method used, potential risk could increase as a result of shifting the payment allocation from principal to interest, thus extending the amortization period. For example, if the minimum payment method is based only on a flat percentage of the balance, the credit card accounts could become subject to limited re-pricing opportunities. If the assigned interest rates get too high (such as under certain penalty-pricing scenarios), whether the bank is meeting reasonable amortization guidelines could come into question when the increased interest charges take up a higher and higher portion of the minimum payment. If management does not intend to change its flat percentage minimum payment structure, it may have no choice but to not raise the interest rate on the card in order to maintain a reasonable amortization period.

Contractual Interest Rate Ceilings And Floors For Adjustable-Rate Items

The IRR Policy Statement notes that information included in the measurement system generally includes contractual interest rate ceilings and floors for adjustable-rate items. In certain situations, a bank could have a high volume of adjustable-rate credit card loans that are indexed at or below the set floor rate. Consequently, when interest rates rise, funding costs might adjust immediately whereas pricing on those card accounts where the rate is already below the floor may not change or may not change to the degree that funding costs change.

Securitization Considerations

If applicable, examiners should look for evidence that the bank's risk sensitivity analysis considers securitizations. Interest rates are important inputs in choosing discount rates[12] for valuing residual interests, which could be sizeable balance sheet components, and rate changes could substantially affect the carrying values. The Risk Management Credit Card Securitization Manual discusses valuing residual interests and stressing the **excess spread** and Interest Only (IO) strip.

[12] Discount rate as used here differs from the term that is used in the Merchant Processing chapter and the glossary. Discount rates for valuing residual interests are discussed in the Risk Management Credit Card Securitization Manual.

Hedging Strategies And Products

Complex, illiquid hedging strategies or products can impact a bank's IRR position. However, they are beyond the scope of this manual due to their potential complexity. Examiners may need to call on capital markets specialists when such activities are encountered.

SUMMARY OF EXAMINATION GOALS – SENSITIVITY TO MARKET RISK

Examiners determine the level of sensitivity to market risk posed by the bank's credit card operations and incorporate that determination into the overall assessment of the bank's sensitivity to market risk. They also determine the impact on capital and earnings. Examiners should consider guidance within the IRR Policy Statement and the Risk Management Manual of Examination Policies and should review data in the UBPR and produced by the Interest Rate Risk Standard Analysis (IRRSA). Procedural analysis generally includes:

- Reviewing the bank's rate sensitivity policies.
- Identifying the bank's acceptable risk tolerance levels.
- Assessing the bank's rate sensitivity risk measurement system and management reports. The assessment should:
    - Identify whether the system is commensurate with the bank's size and complexity, including any credit card programs offered
    - Evaluate whether inputs regarding the card portfolio and associated funding sources are accurate and reasonable.
    - Determine whether outputs are reviewed and understood by management.
    - Determine the frequency of use and reviews.
- Identifying whether there are any recent or planned changes in strategic direction as related to credit card activities and what rate sensitivity risk implications would be associated with those changes.
- Identifying characteristics of the credit card program and the cardholder base that could impact rate sensitivity and how those characteristics are actually impacting rate sensitivity. Examples include interest-rate floors or caps on variable-rate accounts and subprime customer bases.
- Determining balance sheet components specific to credit card activities. For example, the proportions of variable- and fixed-rate receivables, the size of residual interests from credit card securitizations, and so forth.
- Considering the level of protection provided by earnings and capital.
- Reviewing the bank's audits of the rate sensitivity area and identifying management's actions to address any deficiencies named in those audits.

XVIII. CAPITAL

Capital adequacy is a key element of assessing safety and soundness. The more capital that a bank has, the better cushion it has against insolvency. But, capital is costly in part because it restricts the amount of profitable activities in which a bank may engage. To assess capital, examiners focus on available capital protection in comparison to capital needs as reflected in the bank's risk profile. Capital levels that do not fully support the volume, type, characteristics, and risks of all of the bank's business lines, including credit card programs, are cause for concern. Risk-based capital guidelines and other capital rules establish minimum capital ratios, but those banks exposed to a high or above average degree of risk are expected to operate significantly above those ratios. Banks engaged in credit card lending activities, particularly subprime programs, are easily exposed to risk levels that may warrant higher capital protection.

Because banks are exposed to varying degrees and types of risk, any comprehensive capital-adequacy determination is made on a case-by-case basis and considers a wide range of both quantitative and qualitative factors. It involves many dimensions of assessments which consider capital requirements as set forth in PCA regulations and other capital-based rules as well as factors that require a combination of analysis and judgment. While capital ratios provide an initial approximation of a bank's ability to withstand adversity, they may not be absolute indicators of the level of the bank's vulnerability and should be considered in the context of qualitative factors.

This chapter highlights the ongoing evolution of the Basel capital accords and discusses customary capital analyses for credit card programs, including qualitative and quantitative factors.

BASEL CAPITAL ACCORDS

The Basel capital accords are international regulatory agreements that provide a framework for determining the minimum capital that must be held as a cushion against insolvency. The accords require a bank to hold more capital as its asset profile becomes more risky.

Basel II Framework

In June 2004, the Basel Committee on Banking Supervision released a document entitled *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, otherwise known as Basel II. Basel II is designed to create incentives for entities to improve their risk measurement and management processes and to better align minimum capital requirements with the risks of the entity's activities. It is geared to large, internationally-active banks, but certain other large and/or complex banks will more than likely be expected to perform similar risk quantification and capital analyses regardless of whether they are subject to Basel II. This is particularly important when more traditional capital adequacy measures may not adequately capture the inherent risk of activities, such as for securitizations.

The Agencies are in the process of establishing and implementing a comprehensive plan to incorporate Basel II's provisions into regulations and supervisory guidance. On October 27, 2004, the Agencies published the proposed supervisory guidance, *Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital* (Retail IRB Guidance), with request for comment. At that point, the Agencies had issued, in draft form, three critical pieces of supervisory guidance - Corporate IRB, Retail IRB, and Advanced Measurement Approaches (AMA) (with AMA used for operational risk approaches). The three documents are intended to help the Agencies in drafting a notice of proposed rulemaking (NPR) for revised capital adequacy standards. As currently proposed, certain banks would be required to adopt the IRB and AMA approaches while other banks that meet certain criteria would have the ability to opt-in. Many banks that expect to adopt Basel II have already commenced planning their implementation efforts, based on the aggregate proposed guidance. Aspects of the Retail IRB Guidance, which would apply to credit cards, are highlighted next.

IRB Systems for Retail Credit Risk

The Retail IRB Guidance is only a proposal as of this writing. Nevertheless, it does reflect the current views of the Agencies, some of which may ultimately become part of the NPR and some of which are highlighted here. Examiners must consistently remain abreast of proposals (including changes thereto) and forthcoming final rulings regarding Basel II implementation.

The proposed Retail IRB Guidance identifies three retail risk categories, one of which is Qualifying Revolving Exposures (QRE). QREs would be exposures whose outstanding amount fluctuates, determined largely by the borrower's decisions to borrow and repay, up to a pre-established limit. To qualify, the exposure would have to be revolving, unsecured, and unconditionally cancelable by the bank. It would also have to reflect a maximum exposure of $100,000 or less. QREs would include most credit cards to individuals (but not those issued on behalf of a business). Other credit cards would be measured elsewhere in the framework.

The Retail IRB Guidance describes proposed components and characteristics of a qualifying IRB framework. In summary, IRB banks would be expected to construct and maintain a retail credit system comprised of four interdependent components: segmentation, quantification, data maintenance, and control and oversight mechanisms.

- *Segmentation* - For segmentation, banks would assign risk parameters to pools of exposures with similar risk characteristics (or risk segments), rather than to individual exposures. In this phase management would need to determine whether the assignment of retail exposures to segments effectively separates exposures by characteristics that remain significant drivers of risk over time.
- *Quantification* - For quantification, management would statistically estimate three risk parameters for each retail segment: PD – Probability of Default; LGD – Loss Given Default; and EAD – Exposure at Default. For this phase, management would have to determine whether the risk parameter estimates are accurate and representative of the risk in the existing portfolio.
- *Data Maintenance* – Data structures and practices adopted would be unique to each bank. Nevertheless, the data systems would need to be of sufficient depth, scope, and reliability to implement and evaluate the IRB retail credit risk system. They would need to be able to:
    - Develop a risk segmentation system and assign retail exposures to segments.
    - Develop a quantification process and assign risk parameter estimates to segments.
    - Validate the IRB risk segmentation system criteria and architecture.
    - Validate the IRB risk parameter estimates.
    - Produce internal and public reports.
    - Support the overall retail credit risk management process.
- *Control and Oversight Mechanisms* – Banks would have flexibility in establishing appropriate control and oversight mechanisms. However, the mechanisms would have to include controls over lending activities, independent review, transparency, accountability, use of risk parameter estimates for internal risk management purposes, internal and external audit, and board and senior management oversight.

Regulators would evaluate compliance with the four components as well as how well the various components complement and reinforce one another to achieve the overall objective of accurately determining required regulatory capital.

Although banks would be able to designate some retail exposures as nonmaterial (and not subject to the IRB approach), the aggregate amount of nonmaterial retail exposures and their credit risk would have to be small as percentages of total retail exposures and total amount of retail exposure credit risk. Subject to supervisory review, minimum capital requirements for a nonmaterial retail portfolio would be based on the risk-based capital standards for non-IRB banks, which are also evolving.

Revisions to Basel I

The Agencies believe that it is important to update their risk-based capital standards to enhance the risk-sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions (such as those that may be raised by implementation of Basel II). As such, the Agencies are considering a number of revisions to their Basel-I based regulations, including:

- Increasing the number of risk-weighting categories.
- Expanding the use of external credit ratings.
- Requiring that certain loans 90 days or more past due or in a nonaccrual status be assigned to a higher risk-weight category.
- Increasing risk sensitivity of capital requirements for retail exposures.
- Assessing a risk-based capital charge to reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.

Examiners need to be cognizant of the risk-based capital standards, including any changes thereto as a result of these or other future proposals. The Agencies are not currently proposing revisions to the existing leverage capital requirements.

ASSETS

Asset quality problems emanating from the credit card portfolio can quickly deplete capital. To evaluate capital, consideration is given not only to the nature, trend, and volume of problem credit card assets and the adequacy of credit card loan loss allowances, but also to the unique features of credit card portfolios. The portfolio’s typically large quantity of geographically-diverse, revolving accounts with relatively low outstanding balances makes the asset structure of credit card banks very different from other commercial banks and tends to limit the amount of risk on an account-by-account basis. However, actions such as lowering underwriting standards or using improper account management techniques tend to raise the level of credit risk in the aggregate portfolio. As such, the evaluation of capital should consider items such as management’s target market, changes in underwriting or servicing standards, and account management practices.

Management's ability to adequately plan for and manage asset growth is also important with respect to assessing capital adequacy. The examiner normally reviews past performance and future prospects as well as compares asset growth to capital formation during recent periods. In addition to discussions with management, the bank’s budgets and strategic plans are typically items reviewed to identify growth plans.

Asset risk-weightings under the risk-based capital rules account for the relative credit risk of different instruments. However, the guidelines do not appropriately account for weak or valueless assets held by a bank. Lower quality assets have a greater potential for loss and should be reflected in a stronger capital base. Subprime credit card loans, an example of a typically lower quality asset, are discussed next.

SUBPRIME CREDIT CARD LOANS

Banks often refer to the subprime market by other names such as the nonprime, nonconforming, or high coupon market. Regardless of the name used, subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Examiners should direct their attention to situations in which the bank cannot or does not provide a sufficient level of capital support in relation to the volume and nature of the additional risks assumed. Banks with subprime credit card programs frequently have more exposure to certain risks in comparison to other banks. For example, greater credit, legal, and reputation risks are often evident. Banks that engage in subprime credit card lending without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized.

The minimum risk-based and leverage capital ratios established by existing regulations generally apply to portfolios that exhibit substantially lower risk profiles than those which exist in subprime credit card programs and, thus, may not be sufficient to reflect the risks associated with subprime programs. The additional capital that may be necessary varies according to the volume and type of activities and the adequacy of the bank's risk management program. Thus, evaluation of capital adequacy for each subprime lender is conducted on a case-by-case basis. The evaluations may show that certain subprime pools do warrant increased supervisory scrutiny and monitoring but not necessarily additional capital. On the other hand, they often show that higher-risk subprime pools, such as those that contain unsecured loans or high LTV loans, need significantly higher capital protection.

Given the risk inherent in subprime lending programs, the *Expanded Guidance for Evaluating Subprime Lending Programs* (Expanded Subprime Guidance) cites a reasonable starting point as holding capital against such portfolios in an amount that is 1.5 to 3 times greater than what is appropriate for non-subprime assets of a similar type. Refinements (either up or down) depend on various factors, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral protection. There is no definitive guidance in assigning additional risk-weightings to the subprime portfolios or identifying an appropriate level of capital. In that respect, segmentation is a valuable and frequently used tool for determining reasonable capital requirements and helps to map certain portfolio characteristics to appropriate risk-weightings. There have been instances in which risk-weightings towards the higher end of the starting point range (and once in a while even higher) for certain portfolio segments have been warranted and assigned.

Ultimately, banks with subprime programs should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated banks that are not engaged in subprime lending or other similar, high-risk activities. Those subprime lenders that are in a growth mode or that have not been in the business for a sustained period may likely require even higher levels of capital due to less predictability of the business.

The March 1999 *Interagency Guidance on Subprime Lending* (Subprime Guidance) clearly states that management is responsible for determining how much additional capital is needed to offset the additional risk posed by undertaking subprime lending activities, and the Expanded Subprime Guidance emphasizes that management is expected to fully document the methodology used.

The examiner's evaluation of capital adequacy considers, among other factors, the bank's capital allocation methodology. Concerns normally arise when the sophistication of the bank's analysis is not consistent with the size, concentration level, and relative risk of the subprime lending activities and/or when it fails to consider:

- Portfolio growth rates.
- Trends in the level and volatility of expected losses.

- The level of subprime loan losses incurred over one or more economic downturns, if such data is available.
- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets.
- Any deterioration in the average credit quality over time due to adverse selection or retention.
- The amount, quality, and liquidity of collateral securing the individual loans.
- Any asset, income, or funding source concentrations.
- The degree of concentration of subprime credits.
- The extent of residual assets or other potentially volatile components. Securitization is discussed in a separate heading later in this chapter.
- The degree of legal and/or reputation risk undertaken.
- The amount of capital necessary to support the bank's other risks and activities.

The supervisory approach expects capital levels to be risk sensitive (that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters) and expects that a direct link between the estimated loss rates used to determine the allowances and the unexpected loss estimates used to determine capital is established.

Examiners also check to see if results of stress-tests are properly considered and documented in the bank's capital adequacy analysis. The Expanded Subprime Guidance discusses the types of modeling and stress-testing that may be appropriate depending on the size, concentration level, and relative risk of the program. Concerns arise if management does not project the performance of subprime loan pools under various stress scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions, or if management does not incorporate shock-testing basic assumptions, such as delinquency rates, loss rates, and recovery rates on collateral. Scrutiny could also be greater when testing does not consider other potentially adverse scenarios, such as changing payment rates, utilization rates, and credit score distributions. Whether stress tests are performed manually, or through automated modeling techniques, examiners generally expect them to reflect:

- A clearly documented and rational process that is easily understood by management.
- Reliable inputs that relate directly to the subject portfolios.
- Well-documented and conservative assumptions.
- A comprehensive validation process for any models used.

EARNINGS AND DIVIDENDS

Poor or deteriorating earnings performance and/or poor earnings retention can hinder internal capital formation. As such, the current level, historical trend, and sustainability of earnings are significant factors in evaluating capital. For some banks, the ability to securitize a significant portion of the loan portfolio has contributed to a significant amount of non-interest income. The evaluation of capital should consider management's ability to maintain competitive in the market while generating a sufficient interest margin and restraining credit losses. It should also assess management's ability to control overhead expenses and should evaluate securitization activities. Excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. Excessively low dividends can also hurt some banks because low returns weaken the attractiveness of stock to investors, thereby potentially hindering the bank's ability to raise additional equity if needed.

FUNDS MANAGEMENT

The supervisory approach used normally considers funds management when determining whether capital is adequate. Lower levels of liquidity and higher levels of interest rate risk tend to demand higher capital levels than would otherwise be expected. As discussed in the Liquidity chapter, examiners consider consumers' behavioral patterns (including payment and purchasing patterns), the bank's access to the financial markets, and the strength of the parent company when assessing liquidity. Access to capital sources, including holding company support, is a vital factor in analyzing capital. The relationship with the parent company should be evaluated in much the same manner as it would be for any other bank. For example, the approach will normally consider the levels of financial support the parent can provide, debt of the parent, and dividends up-streamed to the parent.

As also discussed in the Liquidity chapter, many banks rely on funding sources such as brokered deposits or securitizations. Securitizations can enhance both credit availability and profitability but can also involve risks that might not be fully recognized by management or adequately incorporated into risk management systems. According to the Subprime Guidance, banks actively involved in the securitization of subprime loans should develop a CFP that includes measures for raising additional capital.

SECURITIZATION

Regulators expect banks to fully support securitization activities with adequate capital. Higher capital requirements may be necessary depending on the structure and the composition of retained interests. Capital treatment for securitization components is complex and is only briefly touched on here. As such, examiners should refer to the Regulatory Capital chapter of the Risk Management Credit Card Securitization Manual and other guidance referenced under each subsection to follow.

Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, and Residual Interests

On November 29, 2001, the federal banking agencies published a final rule revising the regulatory capital treatment of **recourse** arrangements and **direct credit substitutes**, including residual interests and credit-enhancing interest-only strips (CE IO strips). Examiners should reference these materials for full guidance:

- Part 325 of the FDIC Rules and Regulations.
- Report of Condition and Income instructions.
- FIL-99-2001, *Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities*.
- FIL-54-2002, *Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations*.
- Regulatory Capital chapter of the Risk Management Credit Card Securitization Manual.

The regulatory capital rule, as amended in November 2001, includes these broad standards:

- It varies the capital requirements for positions in securitizations according to relative risk exposure, using credit ratings from rating agencies.
- It permits the limited use of a qualifying internal risk-rating system for certain unrated direct credit substitutes.
- It permits the limited use of a rating agency's review of the credit risk of positions in structured programs and qualifying software for certain unrated direct credit substitutes and recourse exposures (but not residual interests).
- It requires banks to deduct CE IO strips, whether retained or purchased, that are in excess of 25 percent of Tier 1 capital from Tier 1 capital and from assets (concentration limit).

- It requires a bank to maintain risk-based capital in an amount equal to the face amount of a residual interest that does not qualify for the ratings-based approach (including CE IO strips that have not been deducted from Tier 1 capital). This is referred to as dollar-for-dollar capital.
- It permits each agency to modify a stated risk-weight, credit conversion factor, or credit equivalent amount, if warranted, on a case-by-case basis.

Examiners should apply this rule to the substance, rather than the form, of the securitization.

Low-Level Exposure Rule:

The capital rule imposes a concentration limit on CE IO strips and a dollar-for-dollar capital charge on residual interests. In no event will this combined capital charge exceed the face amount of a bank's residual interests (low-level exposure rule). The instructions for schedule RC-R - Regulatory Capital of the Report of Condition explain the two methods used to calculate risk-based capital requirements: the direct reduction method and the gross-up method.

Implicit Recourse

If the selling bank provides credit support beyond contractual obligations to receivables considered sold under GAAP, it may be providing implicit recourse and as such, would generally be required to hold capital against the entire outstanding amount of receivables sold for risk-based capital purposes. Examiners should refer to FIL-52-2002, *Interagency Guidance on Implicit Recourse in Asset Securitizations*. Implicit recourse takes on many forms, generally including these post-sale actions:

- Selling assets to the securitization trust at a discount from the price specified in the securitization documents.
- Purchasing assets from the securitization trust at an amount greater than fair value.
- Exchanging performing assets for nonperforming assets.
- Funding credit enhancements beyond contractual requirements.

If any of these situations were evident at the time of the initial transaction, the transaction would not qualify as a sale under GAAP. Thus, if the bank provides such support after the initial sale, it stands to reason that the underlying receivables should not be treated as sold for regulatory capital purposes, and that the bank should hold capital against these assets as if they were still on the bank's balance sheet.

Accrued Interest Receivable (AIR)

In general, the AIR asset represents a subordinated retained interest in cash flows that are initially allocated to the investors' portion of the securitization and is subject to higher capital requirements. Examiners should refer to FIL-48-2002, *Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations*. The guidance discusses reasons why the AIR is considered a subordinated interest, the main reason being that if and when the bank collects any portion of the AIR, the cash collected must be included in the cash flow that runs through the securitization vehicle and thus serves as a credit enhancement to protect third-party investors from credit losses. The AIR meets the definition of a recourse exposure, and as such, the bank must hold risk-based capital against the full, risk-weighted amount of the assets transferred with recourse, subject to the low-level recourse rule. It also meets the definition of a residual interest, which requires dollar-for-dollar capital even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.

CONTINGENT LIABILITIES

Lawsuits are one form of contingent liability that should be considered in the capital analysis, namely when the lawsuit's outcome may impact the bank's financial condition. Examiners must fully understand the essential points upon which the lawsuit is based, the total dollar amount of the plaintiff's claim, the basis of the bank's defense, the status of any negotiations toward a compromise settlement, and the opinion of bank management and/or counsel relative to the probability of a successful defense. Determination of Potential or Estimated Losses in connection with lawsuits is often difficult, and there may be occasions where damages sought are of such magnitude that, if the bank is unsuccessful in its defense, it could be rendered insolvent. In addition to stemming from a direct action (or inaction) by a bank, lawsuits may stem from outsourcing or other third-party arrangements.

Contingent liabilities also typically include a high level of unused loan commitments. These commitments sometimes exceed on-balance sheet assets as well as Tier 1 Leverage Capital by several multiples. Although many commitments can be terminated at any time, the examiner should evaluate management's policies and practices to cancel these commitments in relation to the level of capital.

Reserving for Rebate Programs

Many banks offer rebate programs. Rebates come in many forms such as frequent flier miles, automobile discounts, and cash rebates. In many instances, the contingent liability attributable to the rebate rests with the bank and is based on a rebate formula involving sales volume (in dollars) or a similar measurement. The agreement usually determines the bank's cost, marketing requirements, and potential liabilities of the program. Examiners should assess whether management, before entering into an agreement, specifically considers the contingent liability when establishing pricing for the relationship. Generally, banks have based the amount of the rebate on the historical percentages of consumers carrying interest-bearing balances, and some banks use a teaser rate in conjunction with the program. Thus, incorrect assumptions or projections about the amount of finance charges or fees expose the bank to potential losses. The examiner is tasked with judging the reasonableness of management's reserve method and level for future contingent liabilities. Analysis of the rebate reserve should be similar to analysis of the ALLL. It should consider how long the program has been in existence, whether significant methodology modifications have occurred, what type of product the partner is promoting, and what kind of rebate limitations exist. Examiners also evaluate management practices for periodically reviewing and revising its rebate reserve policies. In general, examiners should expect policies to address:

- How often the analysis is to be prepared.
- How monthly accruals will be handled.
- The attestation of management on the adequacy of the reserve.
- Approvals for changes in reserve levels.
- The accounting for redemptions.
- How over- or under-reserves will be handled.
- Procedures governing internal controls.

QUALITY OF MANAGEMENT

The absence of strong supervision will likely ultimately lead to a deterioration of bank capital. As such, the experience, ability, integrity, depth, and succession of management are critical components in the evaluation of capital. Consideration should be given to management's overall strategic direction which includes risk and account management procedures, policies, data processing facilities, internal and external reporting, and internal controls.

RISK DIVERSIFICATION

Generally, a greater degree of defined asset and liability concentrations increases the need for capital. Both examiners and management should consider whether any on- or off-balance sheet concentrations exist. Concentrations in higher-risk assets may warrant higher holdings of capital.

OPERATING PROCEDURES AND CONTROLS

Inefficient or lax operations are costly and can substantially impact a bank's capital position. Short-comings in systems, procedures, and controls expose a bank to loss through fraud, defalcation, or employee error. Banks with credit card programs can be especially prone to such exposures because the complex systems, procedures, and controls necessary to effectively operate the program also pose many opportunities for manipulation or other faulty actions. Banks subject to Basel II are required to have processes in place to measure operational risk.

CAPITAL MODELS

The use of **economic capital** and other risk modeling techniques continues to evolve and expand to more industry participants, including some banks adopting Basel II (although economic capital models are not explicitly required). Many banks have adopted advanced modeling techniques intended to improve the ability to quantify and manage risks. The techniques frequently incorporate the internal allocation of economic capital considered necessary to support risks associated with all lines of business or portfolios, such as those associated with credit card lending. The models can provide valuable information that bankers and examiners can use to assess capital adequacy. Existing regulatory capital charges capture only credit, market, and operational risk and do not fully address certain aspects of these risks, such as credit concentration risk. Economic capital models, however, address nearly all risks. Total economic capital requirements as measured by the models typically are higher than the regulatory minimum capital charge.

The supervisory approach used to evaluate a bank's economic capital process varies based on the complexity of the bank and the extent of use by management. In any case, examiners should be aware that while such models are inherently imprecise to some degree or another, there are weaknesses that can make the models overly imprecise. Those include data limitations, erroneous assumptions, insufficient quantification of risks, and potential misuse or misunderstanding of model outputs. Examiners should consider both the adequacy of economic capital processes and the results of such processes in their supervisory evaluation of the bank. They may refer to the Scoring and Modeling chapter because some concepts for scoring models can be applied to economic capital models.

QUANTITATIVE MEASUREMENTS

In addition to qualitative factors, quantitative factors assist the examiner in determining and supporting capital adequacy and most commonly include the Tier 1 leverage, risk-based capital, and Substandard and Doubtful Items to Total Capital plus Ineligible ALLL ratios. The following ratios may also be helpful:

- *Equity Growth to Asset Growth* – This ratio measures the amount of capital support in relation to asset growth and can be an early indictor of capital problems. A ratio of less than one indicates that assets are expanding at a rate greater than capital.
- *Non-Current Credit Card Receivables to Equity Capital and Allowances* – This ratio measures the percentage of credit card loans 90+ days delinquent and nonaccrual loans placed against equity capital and the loan loss allowance. This ratio should be evaluated based on its current level as well as its historical trend.

For a bank that securitizes a significant portion of credit card receivables, capital adequacy should be evaluated in relation to estimated managed assets in addition to the standard quantitative measures. Examiners may want to consider the following ratios:

- *Total Equity Capital to Estimated Managed Assets* – This ratio measures the total amount of equity capital, including preferred stock, as a percentage of estimated managed assets.
- *Tangible Capital to Estimated Managed Assets* – This ratio measures the amount of equity capital less all intangible assets as a percentage of estimated managed assets.
- *Tier 1 Leverage Capital to Estimated Managed Assets* – This ratio measures regulatory Tier 1 Leverage Capital as a percentage of estimated managed assets.

A detailed discussion on credit card securitization activities is housed in the Risk Management Credit Card Securitization Manual.

SUMMARY OF EXAMINATION GOALS - CAPITAL

Examiners must determine whether the bank's capital level adequately supports the bank's activities and risk profile. An assessment of the adequacy of the capital level generally involves:

- Referencing prior ROE and UBPR data to perform level and trend analysis.
- Reviewing the quality of management and the content of its strategic plans.
- Assessing the reasons and sources of any instances of recapitalization.
- Taking into account the Basel-implementing regulations and other supervisory guidance that exists at the time of review (examination date).
- Reviewing management's reports on capital adequacy.
- Determining whether the capital allocation methodology is well-documented and reasonable.
- Determining whether the capital adequacy analysis incorporates appropriate stress-testing.
- Reviewing the nature, volume, and migration of problem credit card assets.
- Incorporating the review of earnings performance, including whether or not it enables the bank to fund its growth and remain competitive.
- Analyzing the bank's dividend practices and plans.
- Investigating pending litigation against the bank and any other contingent liabilities.
- When applicable, documenting and referencing each bank's subprime capital evaluation.
- Considering quantitative measurements.
- Reviewing board reporting to ensure it is sufficient to:
    - Allow for the evaluation risk exposures.
    - Determine that the bank holds sufficient levels of capital relative to identified risk.
    - Incorporate capital needs into the strategic planning process.
- Reflecting on estimated managed assets when the bank is involved in securitization activity.
- Determining if the bank is involved in a rebate program. If it is, examiners generally:
    - Review governing agreements to determine what contingent liabilities exist at the bank level.
    - Review management's accounting policy governing the allowance method.
    - Assess who is involved in the rebate operation, how information is communicated, and how payments are transacted. This assessment is especially needed when the bank uses outside vendors to provide a

variety of these services.
    - Determine if the bank reserves for rebate programs and whether the reserves are adequate.
- Assessing any capital restoration plans.

The following items might signal current or future elevated risk and warrant follow-up:

- The absence of adequate capital policies.
- Aggressive growth strategies, especially if in higher-risk products.
- Asset growth outpacing capital growth.
- High dividend levels.
- Inadequate audit coverage.
- Flawed capital models.
- Growth in nonperforming credit card assets.
- New, high-risk, or atypical products.
- Failure to appropriately establish rebate reserves for rebate programs.

These lists are not exhaustive. Examiners should exercise discretion when determining procedures to apply. If they identify significant concerns, they should expand procedures accordingly.

XIX. MERCHANT PROCESSING

Merchant processing is the acceptance, processing, and settlement of payment transactions for merchants. A bank that contracts with (or acquires) merchants is called an acquiring bank, merchant bank, or acquirer. Acquiring banks sign up merchants to accept payment cards for the network and also arrange processing services for merchants. They can contract directly with the merchant or indirectly through agent banks or other third parties.

A bank can be both an issuing bank and an acquiring bank, but banks most often specialize in one function or the other. Merchant processing is a separate and distinct line of business from credit card issuing. It is generally an off-balance sheet activity with the exception of merchant reserves and settlement accounts, both of which are discussed later in this chapter. Merchant processing involves the gathering of sales information from the merchant, obtaining authorization for the transaction, collecting funds from the issuing bank, and reimbursing the merchant. It also involves charge-back processing. The vast majority of merchant transactions are electronically originated (as compared to paper-based) and come from credit card purchases at merchant locations or the point-of-sale (POS). Merchant processing increasingly includes transactions initiated via debit cards, smart cards, and electronic benefits transfer (EBT) products.

TRANSACTION PROCESS OVERVIEW

The payment networks are the center of the cardholder transaction process and maintain the flow of information and funds between issuing banks and acquiring banks. In a typical cardholder transaction, the transaction data first moves from the merchant to the acquiring bank (and through its **card processor**, if applicable), then to the Associations, and finally to the issuing bank (and through its card processor, if applicable). The issuing bank ultimately bills the cardholder for the amount of the sale. Clearing is the term used to refer to the successful transmission of the sales transaction data. At this point, no money has changed hands; rather, only financial liability has shifted. The merchant, however, needs to be paid for the sale. Settlement is the term used to refer to the exchange of the actual funds for the transaction and its associated fees. Funds to cover the transaction and pay the merchant flow in the opposite direction: from the issuing bank to the Associations, to the acquiring bank, and finally to the merchant. The merchant typically receives funds within a few days of the sales transaction.

In a simple form, the clearing and settlement processes for payments can be illustrated with a standard four-corners model (as discussed in the FFIEC IT Examination Handbook, Retail Payment Systems Handbook (March 2004)). In this model, there is a common set of participants for credit card payments: one in each corner (hence, the term four-corners model) and one in the middle of the diagram. The initiator of the payment (the consumer) is located in the upper left-hand corner, the recipient of the card payment (the merchant) is located in the upper right-hand corner, and the relationships of the consumer and the merchant to their banks (the issuing bank and the acquiring bank, respectively) reside in the bottom two corners. The payment networks that route the transactions between the banks, such as Visa, are in the middle of the chart. The information and funds flows for a typical credit card transaction are illustrated in a four-corners model[13] labeled Exhibit D on the next page. Information flows are presented as solid lines while funds flows are represented by dashed lines.

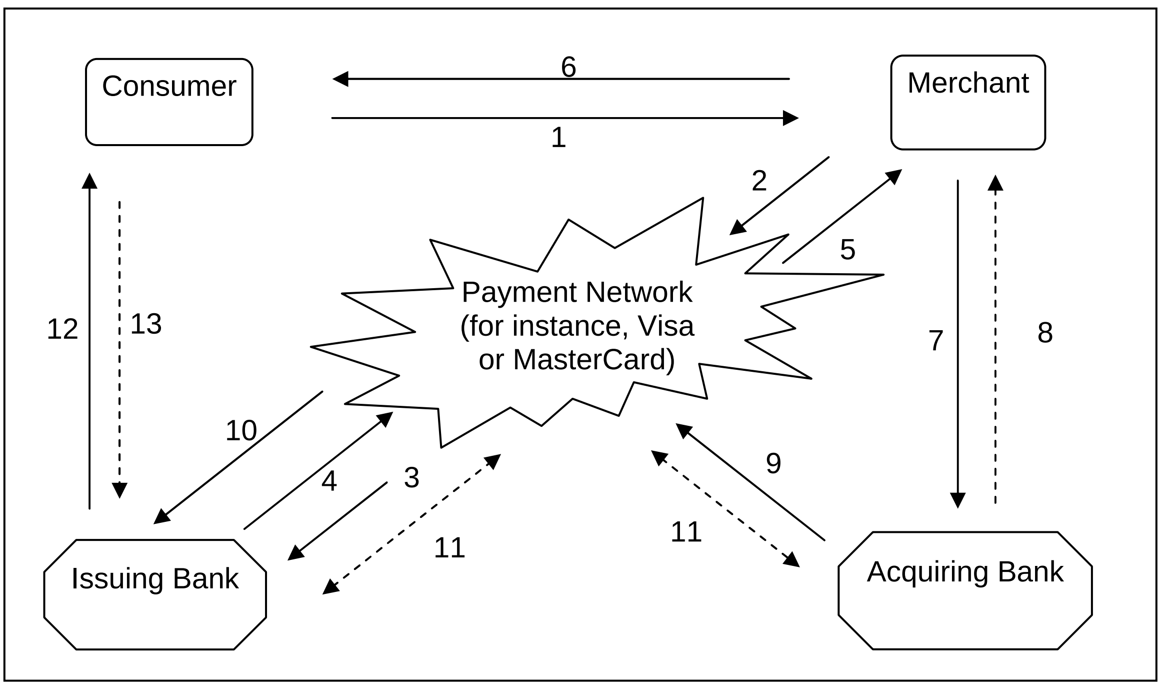
[13] The model and discussion generally mirror the model and discussion that is presented in the FFIEC IT Examination Handbook, Retail Payment Systems Handbook (March 2004).

Step 1:	The consumer pays a merchant with a credit card.
Steps 2 and 3:	The merchant then electronically transmits the data through the applicable Association's electronic network to the issuing bank for authorization.
Steps 4, 5, and 6:	If approved, the merchant receives authorization to capture the transaction, and the cardholder accepts liability, usually by signing the sales slip.
Steps 7 and 8:	The merchant receives payment, net of fees, by submitting the captured credit card transactions to its bank (the acquiring bank) in batches or at the end of the day[14].
Steps 9 and 10:	The acquiring bank forwards the sales draft data to the applicable Association, which in turn forwards the data to the issuing bank.

The Association determines each bank's net debit position. The Association's settlement financial institution coordinates issuing and acquiring settlement positions. Members with net debit positions (normally the issuing banks) send funds to the Association's settlement financial institution, which transmits owed funds to the receiving bank (generally the acquiring banks).

Step 11:	The settlement process takes place using a separate payment network such as **Fedwire**.
Step 12:	The issuing bank presents the transaction on the cardholder's next **billing statement**.
Step 13:	The cardholder pays the bank, either in full or via monthly payments.

Exhibit D



[14] Acquiring banks generally pay merchants by initiating Automated Clearing House (ACH) credits to deposit accounts at the merchants' local banks (possibly an agent bank). If an acquiring bank employs a third-party card processor, the card processor usually prepares the ACH file.

Exhibit D is only a simplistic example of the variety of arrangements that can exist. The parties for the transaction could be one of thousands of acquirers or issuers or one of millions of merchants and consumers. Further, there are many other ways the arrangements can be structured. For example, in on-us transactions, the acquiring bank and the issuing bank are the same. Also, the timing of the payment to the merchant (step 8 of Exhibit D) varies. Some acquiring banks pay select merchants prior to receiving funds from the issuing bank, thereby increasing the acquiring bank's credit and liquidity exposure. However, payment from the acquiring bank to the merchant often occurs shortly after the acquiring bank receives credit from the issuing bank.

The presence of third-party organizations coupled with the acquiring bank's ability to sub-license the entire merchant program, or part thereof, and the issuing bank's ability to sub-license the entire issuing program, or part thereof, to other entities also introduces complexities to the transaction and fund flows. For example, because the cost of technology infrastructure and the level of transaction volume are high for acquiring banks, most small acquiring banks rely on third-party card processors to perform the functions. In addition, issuing banks often use card processors to conduct several of their services. In intra-processor transactions, the same third party processes for both the acquiring bank and the issuing bank. Under the by-laws and operating rules/regulations of the Associations, the issuing banks and acquiring banks are responsible for the actions of their contracted third-parties, respectively.

A merchant submits sales transactions to its acquiring bank by one of two methods. Large merchants often have computer equipment that transmits transactions directly to the acquiring bank or its card processor. Smaller merchants usually submit transactions to a vendor that collects data from several merchants and then transmits transactions to the acquiring banks.

RISKS ASSOCIATED WITH MERCHANT PROCESSING

Some bankers do not understand merchant processing and its risks. Attracted to the business by the potential for increased fee income, they might underestimate the risk and not employ personnel with sufficient knowledge and expertise. They also might not devote sufficient resources to oversight or perform proper due diligence reviews of prospective third-parties. Many banks simply do not have the managerial expertise, resources, or infrastructure to safely engage in merchant processing outside their local market or to manage high sales volumes, high-risk merchants, or high charge-back levels. Many of a bank's risks may be interdependent with payment system operators and third parties. For example, the failure of any payment system participant to provide funding for settlement may precipitate liquidity or credit problems for other participants, regardless of whether they are party to payments to or from the failing participant.

For banks that engage in merchant programs or that are contemplating engaging in such programs, examiners should look for evidence that management understands the activity's risks which include credit, transaction, liquidity, compliance, strategic, and reputation risk. A failure by management to understand the risks and provide proper controls over such risks can be very problematic, and even lethal, to the bank. Take, for example, the case of National State Bank, Metropolis, Illinois. Inadequate control of the credit and transaction risks associated with its merchant processing activities contributed to a high volume of losses that ultimately depleted capital, threatened the bank's liquidity, and led to its closing by the Office of the Comptroller of the Currency (OCC) in December 2000.[15]

[15] As per press release PR-90-2000.

Credit Risk

A primary risk associated with merchant processing is credit risk. Even though the acquiring bank typically does not advance its own funds, processing credit card transactions is similar to extending credit because the acquiring bank is relying on the creditworthiness of the merchant to pay charge-backs. Charge-backs are a common element in the merchant processing business and are discussed in more detail later in this chapter. They can result from legitimate cardholder challenges, fraud, or the merchant's failure to follow established guidelines. Charge-backs become a credit exposure to the acquiring bank if the merchant is unable or unwilling to pay legitimate charge-backs. In that case the acquiring bank is obligated to honor the charge-back and pay the issuing bank which could result in significant loss to the acquiring bank. In a sense, the acquiring bank indemnifies a third party (in this case, the issuing bank that in turn indemnifies the cardholder) in the event that the merchant cannot or does not cover charge-back. Banks have been forced to cover large charge-backs when merchants have gone bankrupt or committed fraud. Acquiring banks control credit risk by using sound merchant approval processes and closely monitoring merchant activities.

Transaction Risk

Acquiring banks are faced with the transaction risk associated with service or product delivery because they process credit card transactions for their merchants daily. The risk can stem from a failure by the bank or any party participating in the transaction to process a transaction properly or to provide adequate controls. It can also stem from employee error or misconduct, a breakdown in the computer system, or a natural catastrophe. The acquiring bank needs an adequate number of knowledgeable staff, appropriate technology, comprehensive operating procedures, and effective contingency plans to carry out merchant processing efficiently and reliably. A sound internal control environment is also necessary to ensure compliance with the payment networks' rules. Formal reconciliation processes are also essential to limiting risk.

The high transaction and sales volume normally encountered with merchant processing programs creates significant transaction and liquidity risks. A failure anywhere in the process can have implications on the bank. Examples include an issuing bank's inability to fund settlement to the acquiring bank or a processing center's failure to transmit sales information to the issuing bank, thus resulting in a delay of or failure of funding to the merchant bank.

Liquidity Risk

Liquidity risk can be measured by the ability of the acquiring bank to timely transmit funds to the merchants. Acquiring banks often limit this risk by paying merchants after receiving credit from the issuing bank. If the acquiring bank pays the merchant prior to receiving credit from the issuing bank, the acquiring bank could sustain a loss if the issuing bank is unable or unwilling to pay. Some acquiring banks delay settlement and pay merchants one day after receiving the funds from the issuing bank. The delay allows the acquiring bank time to perform fraud reviews. For delayed settlement, which most commonly occurs when transactions are identified as suspicious or unusual, management is expected to have established formal procedures. Because merchant deposits can be volatile, risk may also arise if the acquiring bank becomes reliant on the merchant's deposits as a funding source for other bank activities. Furthermore, substantial charge-backs could potentially strain the bank's financial condition and/or reputation to such a degree that its creditors may withdraw availability of borrowing lines.

Associations guarantee settlement for transactions that pass through interchange. As a result, they may require collateral pledges/security if a bank's ability to fund settlement becomes questionable. This can create significant liquidity strains and potentially capital difficulties, depending on the size of the collateral requirement and/or the financial condition of the bank.

The Associations' rules allow them to assess the banks directly through the settlement accounts if the bank is not forthcoming with the collateral.

Compliance Risk

Compliance risk arises from failure to follow payment networks' rules and regulations, clearing and settlement rules, suspicious activity reporting requirements, and a myriad of other laws, regulations, and guidance. It can lead to fines, payment of damages, diminished reputation, reduced franchise value, limited business opportunities, reduced expansion potential, and lack of contract enforceability. Acquiring banks can limit compliance risk by ensuring a structured compliance management program is in place, the internal control environment is sound, and staff is knowledgeable. They can also limit risk by providing staff with access to legal representation to ensure accurate evaluation of items such as new product offerings, legal forms, laws and regulations, and contracts.

Strategic Risk

Strategic risk arises from adverse business decisions or improper implementation of those decisions. A failure by management to consider the bank's merchant processing activities in the context of its overall strategic planning is normally cause for concern. A decision to enter, maintain, or expand the merchant processing business without considering management's expertise and the bank's financial capacity is also normally cause for concern. Examiners should also pay close attention to how the acquiring bank plans to keep pace with technology changes and competitive forces. Examiners should look for evidence that the strategic planning process identifies the opportunities and risks of the merchant processing business; sets forth a plan for managing the line of business and controlling its risks; and considers the need for a comprehensive vendor management program. An evaluation of management's merchant processing expertise is critical to judging strategic risk. The bank's overall programs for audit and internal controls, risk management systems, outsourcing of services, and merchant program oversight are key to controlling the strategic risk.

Reputation Risk

Reputation risk arising from negative public opinion can affect a bank's ability to establish new relationships or services or to continue servicing existing relationships. This risk can expose the bank to litigation, financial loss, or damage to its public image. The bank's business decisions for marketing and pricing its merchant processing services can affect its reputation in the marketplace. Reputation risk is also associated with the bank's ability to fulfill contractual obligations to merchants and third parties. Most notably, the outsourcing of any part of the merchant processing business easily increases reputation risk. Decisions made by the acquiring bank or its third-parties can directly cause loss of merchant relationships, litigation, fines and penalties as well as charge-back losses. Concerns normally arise when the acquiring bank does not maintain strong processes for performing due diligence on prospective merchants and third-parties or perform ongoing evaluations of existing merchant and third-party relationships.

MANAGEMENT

Examiners should expect that management fully understand, prior to becoming involved in merchant processing and continuing thereafter, the risks involved and its own ability to effectively control those risks. Merchant programs are specialized programs that require management expertise, significant operational support, and rigorous risk-management systems. It can be a profitable line of business but, if not properly controlled, can result in significant risk to the bank.

Examiners should determine whether qualified management has been appointed to supervise merchant activities and to implement a risk management function that includes a merchant approval system and an ongoing merchant review program for monitoring credit quality and guarding against fraud. Bank staff's knowledge and skill-sets are expected to be commensurate with the risks being taken. For example, personnel responsible for processing charge-backs should have the technical knowledge and understanding of charge-back rules, and personnel responsible for approving merchant applications should have the ability to properly evaluate creditworthiness and identify high-risk merchants.

Examiners assessing risks of merchant programs should direct their attention to situations in which management has not put proper risk measurement systems in place to operate, monitor, and control the activity effectively. This includes situations that evidence the absence of regular management reports detailing pertinent information. Key reports generally include new merchant acquisitions, merchant account attrition, merchant portfolio composition, sales volumes, charge-back volumes and aging, fraud, and profitability analyses.

Examiner attention should be given to instances in which comprehensive, written merchant processing policies and procedures are absent or are not adequate for the size and complexity of operations. Necessary components of policies and procedures generally include:

- Clear lines of authority and responsibility (for example, the level of approval required to contract with certain types of merchants).
- Adequate and knowledgeable staff.
- Markets, merchant types, and risk levels the bank is and is not willing to accept.
- Limits on the individual and aggregate volume of merchant activity that correlates with the bank's capital structure, management expertise, and ability of operations to accommodate the volume (e.g., human and systems resources) as well as with merchants' risk profiles.
- Goals for portfolio mix and risk diversification, including limits on the volume of sales processed for higher-risk merchants and that take into account the level of management expertise.
- Merchant underwriting and approval criteria.
- Procedures for monitoring merchants, including financial capacity, charge-backs and fraud (regardless of who originates the merchants for the bank).
- Criteria for determining appropriate **holdback** or merchant reserve accounts.
- Procedures for settlement, processing **retrieval requests** and charge-backs, handling complaints, monitoring and reporting of fraud, and training personnel.
- Third-party risk management controls.
- Guidelines for accepting and monitoring agent banks.
- Guidelines for handling policy exceptions.
- MIS to keep management sufficiently informed of the condition of, and trends in, the merchant program.
- Audit coverage.

CAPITAL

Examiners should insist that the bank hold capital sufficient to protect against risks from its merchant business. In addition, they should determine whether management has established sound risk limits on the merchant processing volume based on the bank's capital structure, the risk profile of the merchant portfolio, and the ability of management to monitor and control the risks of merchant processing.

Associations limit the processing volume a bank can generate based upon the bank's capital structure, high-risk merchant concentrations, and charge-back rates. Banks operating outside the established thresholds (which may vary and are subject to change) are generally considered to be high-risk acquiring banks by the applicable Association and may be subject to additional activity limits or collateral requirements.

No specific regulatory risk-based capital allocation(s) for merchant processing activities, which, as mentioned, are typically off-balance sheet, exist. Nevertheless, capital regulations permit examiners to require additional capital if needed to support the level of risk. Examiners frequently consider these measurements that take into account the volume of merchant activity:

- Risk Weighted Off-Balance Sheet Items for Merchant Processing = Average monthly merchant sales (Annual Merchant Sales/12) X 2.5 X 20 percent (conversion factor for off-balance sheet items) X 100 percent (risk weight category)[16].
- Tier 1 capital / (Average Total Assets + Risk Weighted Off-Balance Sheet Items for Merchant Activity).

MERCHANT UNDERWRITING

Evidence should corroborate that the bank scrutinizes prospective merchants with the same level of diligence used to properly evaluate prospective borrowers. Concerns may arise when the bank's underwriting does not consider the merchant's ability to cover projected charge-backs as well as its potential risk for fraud, high charge-back rates, and business failure. Merchant underwriting and approval policies generally:

- Define criteria for accepting merchants (for example, acceptable business types, time in business, location, sales and charge-back volumes, and financial capacity).
- Establish underwriting standards for the review of merchants.
- Define what information is required on the merchant application.
- Stipulate what information is required in the merchant agreement.
- Outline procedures and time frames for periodic review of existing relationships.

Merchant Review and Approval

Merchant underwriting provides an opportunity to reject a merchant that the acquiring bank determines has an unacceptable history of charge-back volumes, has a weak financial condition, is not operating a valid business, or is otherwise not acceptable for the bank's program. Limits for personnel approving new merchant accounts are usually based on the merchant's sales volume, and situations in which the designated bank personnel do not have appropriate levels of credit expertise in relation to that volume are cause for concern. Further, if the acquiring bank uses information collected by Independent Sales Organizations (ISOs) / Merchant Service Providers (MSPs), examiners should look for policies and controls to be in place for substantiating the quality of the information provided. In addition to exception guidelines and documentation requirements, underwriting standards generally include:

- A signed merchant application.
- A signed merchant processing agreement.
- A signed corporate resolution, if applicable.
- An on-site inspection report.
- Analysis of credit bureau reports on the principal(s) of the business.
- Evaluation of financial statements, tax returns and/or credit reports on the business.

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[16] This calculation converts the off-balance sheet activity (merchant sales settled) to an on-balance sheet risk-weighted item. The 2.5 figure represents a 2.5 month average liability for charge-backs that is based on the premise that most charge-backs run off within 2.5 months. Technically, there is a potential 6 month window of charge-back liability. The 20 percent figure is the factor to convert the off balance sheet transactions subject to recourse to an on-balance sheet item. The 100 percent figure represents the risk weight applied based on capital regulations. The resulting risk weighted off-balance sheet items for merchant processing would be included in the denominator of the risk based capital ratios.

- Analysis of prior merchant activity, such as the latest monthly statements from the most recent processor.
- Analysis of projected sales activity (for instance, average ticket amount, daily/monthly sales volume).
- Assessment of any existing relationship (for example, a loan) with the bank.
- Consideration of the line of business and/or the product(s) offered by the merchant.
- Verification of trade and bank references.
- Evidence as to whether the merchant is on the Member Alert To Control High Risk Merchants (**MATCH**) system.

Principals:

Proper review by management normally includes conducting a background check on the business's principal(s), scrutinizing personal credit reports for derogatory information, and verifying addresses. Where appropriate and allowed by law, management may also perform a criminal background check.

MATCH:

Association regulations state that acquiring banks must check MATCH before approving a prospective merchant. The database contains a list of merchants that have been terminated for cause or that have made multiple applications for merchant accounts (because submitting applications to more than one acquiring bank simultaneously might indicate fraud). If an acquiring bank denies permission to accept cards to a merchant because of adverse processing behavior and fails to add it to the MATCH list, the acquiring bank can be liable for losses another provider might suffer from that merchant.[17]

If a merchant is listed on MATCH, management is expected to contact the listing bank regarding the termination reasons. MATCH status can help a bank determine whether to implement specific actions or conditions if a merchant is accepted. Examiners should pay attention to instances in which management has not carefully investigated a merchant listed on MATCH or in which their decision to accept or refuse a merchant has been solely based on the merchant being listed or not being listed on MATCH.

On-Site Inspection:

The goal of on-site inspections is to verify a merchant's legitimacy. The absence of documentation of the inspections, including photographs and a written inspection report normally is cause for concern as are situations in which the inspection was conducted by an individual who has a financial interest in its outcome. Acquiring banks signing merchants remotely sometimes find performing inspections themselves difficult or expensive. Often other acquiring banks or third parties will perform site inspections on an exchange or fee basis. In these cases, examiners need to assess whether management is well-informed of the other parties' inspection procedures and ensures that the procedures are, at a minimum, consistent with procedures management would use if conducting a proper inspection itself.

Products and Marketing:

The merchant's line of business and/or the products offered as well as its marketing practices are key factors for management to consider when it evaluates the credit quality of a merchant. The Associations segment merchants according to activity because the type of activity often is a good indicator of risk. Thus, it stands to reason that examiners may expect acquiring banks to

[17] According to the article entitled "Merchant Acquirers and Payment Card Processors: A Look Inside the Black Box," authored by Ramon P. DeGennaro, and housed in the First Quarter 2006 edition of the *Economic Review* (Federal Reserve Bank of Atlanta).

continually analyze their merchant portfolios along similar guidelines. Acquiring banks typically compile a prohibited or restricted merchant list which includes the types of merchants they are unwilling to sign or are willing to sign only under certain circumstances.

While the extent of product and marketing evaluations varies, considerations normally include review of the merchant's business plans, merchandise, and marketing practices and materials (for example, catalogs, brochures, telemarketing scripts, and advertisements). In addition, shipping, billing, and return policies can be reviewed for unusual or inappropriate practices (for instance, customers being billed long before merchandise is shipped). These considerations can help determine, among other things, if: the business is of a type that typically has high charge-back rates; the merchant is selling a legitimate product; sales methods are legitimate and not deceptive; product quality and price are consistent with projected sales and charge-back rates; and customers will be satisfied with products ordered. Merchants offering low-quality products or services tend to incur more charge-backs, thus dissuading many banks from signing them.

The merchant's sales volume and time frame within which product delivery is completed are other considerations to evaluate risk. Generally, the greater the sales volume and the longer the time between transactions and product delivery, the greater the risk. For example, when a restaurant closes, an acquiring bank typically has less exposure to charge-backs for undelivered goods and services. In contrast, the failure of a travel agency could expose an acquiring bank to substantial charge-backs due to the high volume of reservations common in the travel agency business.

Certain types of merchant businesses can present increased risk. Although there are many reputable merchants whose sales transactions occur without a credit card being present (card-not-present merchants), these merchants generally present higher charge-back risks for acquiring banks. In particular, mail order and telemarketing (MO/TO) merchants and adult entertainment services merchants, in aggregate, tend to display elevated incidents of charge-backs. Merchants without an established storefront (for example, door-to-door salesman and flea market vendors) also typically pose greater risk for charge-backs. The risk of charge-back is also higher if the merchant sells products for **future/delayed delivery**, such as airline tickets, health club memberships, travel clubs, or internet purchases. The increased risk associated with future delivery of products results, in part, because customer disputes are normally not triggered until the date of delivery. High charge-back rates are also generally associated with certain selling methods, such as sales pitches involving gifts, cash prizes, sweepstakes, installment payments, multi-level marketing, and automatic renewals unless the consumer opts out. Association regulations define certain broad business categories as high-risk merchants. These categories in general present higher risk, but each individual merchant in the category may not necessarily be high risk. Appropriate procedures and risk controls for high-risk merchants generally include:

- Criteria for determining the types of merchants the bank is or is not willing to sign and under what circumstances.
- Increased emphasis on underwriting considerations regarding products and marketing in evaluating the merchants.
- Limitations on the volume of high-risk merchant transactions processed relative to the bank's total merchant portfolio.
- Criteria for determining the appropriate level of holdback or reserve accounts to sufficiently cover the level of credit risk.
- Appropriate pricing of these merchants in relation to the charge-back risk and any costs associated with increased monitoring.
- Heightened monitoring and problem resolution. For example, for charge-back monitoring, banks may set lower charge-back thresholds for required remedial action and/or a shorter timeline for problem resolution for those merchants exceeding acceptable charge-back thresholds.
- Compliance with bankcard regulations regarding registration of certain high-risk merchants and assigning proper **Merchant Category Codes (MCC)** to merchants.

Merchant Agreements

If management has not sought legal advice when developing merchant agreements and/or referred to network guidelines for contracting, closer scrutiny of such agreements may be warranted. Typical contents of a merchant agreement include but are not limited to:

- Fees and pricing.
- Merchant requirements at POS.
- Requirements for cardholder information security.
- Prohibition of **split sales drafts** and **laundering** of sales drafts.
- Merchant liability (for example, charge-backs and reserves).
- Notification of ownership changes or substantive marketing and product changes.
- Right to hold funds (for example, bank's right to freeze deposits when fraudulent activity suspected).
- Termination provisions.
- Internet provisions (for example, encryption and web-site displays).

Periodic Review

Concerns normally become elevated when management is not monitoring the financial condition of high-volume and high-risk merchants on an ongoing basis and/or when the bank's policy has not addressed the frequency of reviews and the size of merchants requiring reviews. Examiners should assess management's practices for considering volume, concentrations, high-risk industries, and charge-back history in establishing the thresholds for periodic reviews. Depending on the composition of the bank's merchant portfolio, examiners may not necessarily expect the bank to conduct credit reviews of smaller merchants on an ongoing basis if the bank used sound underwriting guidelines at acquisition and if the bank is using strong controls to monitor all merchant transactions, including fraud and charge-back monitoring. Examiners might observe cases in which databases (for items such as risk scores and bankruptcy filings) are used to periodically screen the merchant portfolio.

Communication between merchant program and loan personnel regarding changes in the merchant's credit quality is key part of assessing any shared banking relationships. For example, an unacceptable charge-back rate for a merchant might indicate emerging credit quality problems that could trigger the need to review any lending relationships with the merchant. Likewise, concerns that identify merchants as problem borrowers could trigger the need to review merchant arrangements. If credit information shows deterioration in the merchant's financial condition, the bank may want to reduce its risk exposure from merchant processing. For instance, when dealing with a financially-unstable merchant, the bank might require a holdback or security deposit, as discussed later in this chapter.

Internet Merchants

The lower level of barriers encountered when setting up an Internet merchant increases the risk of fraudulent businesses or businesses with minimal financial resources being established compared to the risks associated with traditional merchants. This risk elevates the need for acquiring banks to conduct thorough underwriting reviews of internet merchants. Whether fraud and charge-back risks warrant additional risk-mitigation techniques, such as delaying settlement or setting up reserves, is a critical decision that normally occurs during the underwriting process.

Electronic commerce via the Internet poses additional privacy and security concerns. The absence of or weak transaction and data security controls for customer transactions and storage of customer information are cause for concern. Secured servers and data encryption technologies help to protect data and transaction integrity. Other items considered normally include whether the merchant meets the following general web site display guidelines:

- Description of goods and services offered.
- Customer service number.
- Company's e-mail address.
- Statement regarding security controls.
- Delivery methods and timing.
- Refund and return policies.
- Privacy statements (permissible uses of customer information).

PRICING

One of the key aspects of a successful merchant program is appropriately setting the fees that the merchant will be charged for sales transactions and acquiring bank services. Merchant pricing is extremely competitive, especially for large- and national-scale merchants who generate high transaction volumes. High transaction volumes can lead to economies of scale and possibly increased income. Examiner should look for evidence that banks have adopted a pricing policy that outlines the methods used for pricing, authority levels, and repricing procedures. A pricing policy can facilitate consistency in pricing practices and help optimize profit margins.

Acquiring banks use various methods to price merchants. Smaller merchants are frequently priced with a single discount rate based on merchant volume and average ticket size. Acquiring banks frequently use unbundled pricing for medium to large merchants. Unbundled pricing is the method of assigning fees for the cost of each service used. Examples of unbundled services include interchange, authorizations, and charge-backs. Other fees may include, but are not limited to: statement preparation, application, customer service, membership, maintenance, and penalty fees (for example, for violating payment network rules).

Examiners should evaluate the bank's practices for ensuring that pricing is consistent with the risk posed by the merchant. Acquiring banks sometimes use a pricing model to determine the target discount rate. They might maintain one or more pricing models, with model usage driven by the merchant's sales volume and/or industry classification. Pricing models allow the acquiring bank to quickly substitute variables regarding sales volumes, average ticket size, revenues and expenses to produce a projected profit margin. A failure of the pricing model to include all direct and indirect expenses may render the model's results meaningless. A model's accuracy depends upon the reasonableness of the assumptions used.

Pricing Components

Discount Rate:

Acquiring banks assign a discount rate for each merchant when the merchant agreement is signed. The discount rate is the percentage that gets "discounted" off the transaction amount that is paid to the merchant, hence the term discount rate. In a simple case, the discount represents a single rate charged to a merchant based on the merchant's sales volume. For example, a merchant with a 2 percent discount rate receives $98 for a $100 credit card sale. Most merchant agreements allow the acquiring bank to change the discount rate for various cost increases. Numerous factors influence the discount rate charged, including, but not limited to, the transaction method, processing volume, and type of merchant business. For example, merchants who use **electronic data capture (EDC)** are typically charged lower discount rates than paper-based merchants. Discount rates generally range from 1 to 4 percent for small to medium-size merchants and sometimes well below that range for large-volume merchants.

When considering the range of discount rates used by the bank, examiners should call on management to readily explain outliers, including those that are well below the normal range. Banks sometimes give merchants a favorable discount rate because of existing commercial loan or deposit relationships. In other cases, the discount rate is favorable due to a credit card equipment lease arrangement. Packaging may be an acceptable practice, but does not eliminate the need to measure the overall profitability of a merchant relationship. Further, examiner attention should be drawn to situations in which management has offered favorable discount rates to insiders or their related interests.

Interchange Fees:

Interchange fees represent compensation paid by the acquiring bank to the issuing bank. Thus, they are recorded as an expense on the acquiring bank's income statement and as a revenue source on the issuing bank's income statement. Interchange fees are based on several factors such as volume, size, and type of transaction and are usually set by the Associations. They average less than two percent of the purchase price and are typically one of many considerations in determining the size of the discount rate that the acquiring bank charges the merchants. (For on-us transactions, interchange may be reduced, if not entirely eliminated.) A number of merchants and merchant groups have filed lawsuits alleging that the interchange fees set by the Associations for credit card transactions violate anti-trust laws and that the fees paid to accept payment cards are too high. In last quarter of 2006 the Associations began offering pubic access to interchange rate information.

Processing Fees:

Processing fees cover the costs associated with data processing services and vary depending on the size and number of transactions the merchant submits per batch. The processing fee may include data capture and authorization costs. It might go directly to the bank if it handles the processing or to the bank's third-party processor.

ISO/MSP Fees:

The ISO/MSP fee is the amount the acquiring bank pays the ISO/MSP for services provided. It is negotiated and often represents a percentage of the volume that the ISO/MSP-sponsored merchants bring to the bank. The fee agreement between the bank and the ISO/MSP is normally considered when pricing merchants obtained through an ISO/MSP.

Agent Bank Commission:

The agent commission is a fee passed to the agent bank for signing a merchant. This fee could be built into the discount rate or be assessed separately.

Other Income:

Acquiring banks sometimes offer other programs to generate fee income (for instance, equipment leasing). Instances in which management has not researched the legal and compliance aspects of products or services offered or has not priced the programs adequately warrant scrutiny.

Monitoring Pricing

Examiners should evaluate management's practices for ensuring that merchants are priced appropriately throughout the life of the contract. Best practices by management may include verifying actual volumes and ticket sizes after signing a new merchant (for example, at six months into the relationship) to ensure consistency with volumes and ticket sizes anticipated. Examiners should assess management's practices for ensuring the discount rate is in line with the application estimate and original pricing model assumptions. In general, a failure by management to review all significant merchants for repricing at least annually elevates concern. Further, if any merchants are or have been unprofitable, examiners should accordingly inspect management's repricing practices for those merchants. Merchant agreements typically allow acquiring banks to increase pricing at any time during the contract's life.

Profitability Analysis

Merchant programs can be profitable. Although competition with third-party processors has lowered margins, banks have been able to compete due to their strong marketplace presence. Banks are able to generate new merchant accounts through their branch networks and existing customer relationships.

Merchant processing is characterized as a high transaction volume, low profit margin business. Only efficiently run departments with strong cost controls can operate profitably. Examiners should analyze profitability reports used by the bank to measure the profitability of the merchant processing operations to determine if it is consistent with the size and complexity of the operations. Reports should detail key performance measures such as net income to sales and net income per item. Ideally, it should be able to segment profitability by merchant, acquisition channel, and industry.

Examiners should normally expect profitability analyses for merchant operations to be distinctly separate from the analyses of other banking activities and to include all direct and indirect costs. Direct costs include costs such as those for internal data processing, merchant accounting, fraud and charge-back losses, personnel, and occupancy. Indirect costs may include corporate overhead expenses such as those for human resources, legal, and audit services. The level of detail and frequency of board reporting is contingent on the size of the operation in relation to the overall operations of the bank and its capital base.

FRAUD MONITORING

Management's ability to quickly detect fraudulent activity is important in controlling losses. The merchant, then its acquiring bank, are the parties liable for certain types of losses. Persons possessing stolen credit cards sometimes take advantage of unsuspecting store clerks, or merchants sometimes perpetrate fraud. Merchant fraud can be extremely costly if not discovered quickly. Examples of merchant fraud include **factoring** and draft laundering. New merchant accounts are particularly susceptible to fraud such as **bust-out scams**. Examiners should insist that banks have a fraud detection system to identify and monitor potentially fraudulent activity.

Fraud Detection Methods

Fraud identification that relies exclusively on excess charge-back activity analysis is normally cause for concern because there are a number of other indicators that can point to fraud. A primary tool used by management for fraud detection is an exception report that details variances from a multitude of parameters established at account set-up. Along with charge-backs, basic parameters usually include daily sales volume, average ticket size, multiple purchases of the same dollar amount, multiple use of the same cardholder number, percentage of keyed versus swiped transactions (because keyed transactions frequently are associated with card-not-present transactions which are normally higher-risk), number of authorizations declined, authorizations during non-business hours, and high volume of authorizations in relation to transactions. A daily exception report lists merchants that are outside of any of the parameters.

Most large-volume processors have established exception parameters based on industry or merchant type. Examiners should review management's practices for periodically updating parameters. For example, management might set the daily sales threshold at a percent of a prior timeframe's activity (for instance, 110 percent of the three months' average). The margin allows for normal growth of the merchant and compensates for seasonal sales patterns.

Some banks use neural network technologies for fraud detection. These complex computer programs can compare each transaction against the merchant's prior sales patterns. Though more sophisticated than a traditional exception report, smaller merchant processors may be unwilling or unable to purchase these technologies on an ongoing basis. Instead, some acquiring banks selectively route higher-risk transactions through a neural network while confining the remainder of transactions to exception reporting.

Some banks also use Informational databases (such as those for scoring, bankruptcy, trade, and fraud) to identify at-risk merchants. Merchants that have financial or legal difficulties often have a higher propensity to falsify transactions.

Associations provide educational materials to acquiring banks and merchants about the industry's latest fraud detection techniques. They also prepare fraudulent activity reports for each acquiring bank. The reports are not intended to replace the bank's own fraud system. Rather, examiners should expect to see that such reports supplement the internal system. Certain circumstances require management to document its plan to correct a merchant's unacceptable sales practices.

Inactive merchant accounts can signal potential fraud. For example, inactivity could signal a bust-out scam wherein a fraudulent merchant signs with several acquiring banks simultaneously, moving from one to the next as the scam is perpetrated or detected. When exception reports flag an inactive account, management normally follows up with the business owner.

Other potential warning signs of fraud generally include:

- Evidence that credit card purchases have been intentionally structured by a merchant to keep individual amounts below the "floor limit" to avoid approval requirements.
- Merchant account activity that reflects a substantial increase in the number and/or size of charge-backs.
- Merchant's deposit of sales drafts made payable to a business or businesses other than the business named on the account.
- Merchant's frequent request that funds be wire transferred from the merchant account to other institutions in other parts of the country or to offshore institutions almost immediately after deposits are made.
- Merchant that is engaged in telemarketing activities and is the subject of frequent customer complaints.
- Merchant account deposits that appear to exceed the level of customer activity observed at the merchant's place of business.
- Merchant that has access to electronic data capture equipment but frequently inputs credit card account numbers manually (for example, if manually keyed transactions exceed 10 percent of total transactions).
- Merchant that has a sudden or unexplained increase in the level of authorization requests from a particular merchant location.

Fraud Investigations

Examiners must expect management to take swift action when it encounters suspicious transactions or other suspicious activity. Management's investigation may include verifying purchases with the issuing bank and/or obtaining copies of paper-based transaction tickets from the merchant. An acquiring bank's quick response will help minimize losses to it and the issuer as well as provide timely information to law enforcement agencies. Changes in a merchant's business operations such as changes in ownership, business principals, bank accounts, merchandise, sales methods, or target market normally also warrant an investigation.

Merchant agreements normally allow the acquiring bank to delay settlement until questionable transactions are resolved. Once fraud is suspected, management must follow Suspicious Activity Report (SAR) guidelines. Examiners should evaluate the bank's processes for terminating fraudulent merchant accounts and placing such merchants on MATCH. They should also consider the acquiring bank's and its processor's practices for suspending or blocking settlement and authorization processing to a terminated merchant's account. Such procedures are intended to prevent further deposits and **account testing**.

CHARGE-BACK PROCESSING

Credit risk arising from charge-backs is an acquiring bank's primary risk and can result in significant financial loss. If a merchant is unable to pay its charge-backs, the acquiring bank must pay the issuing bank. Large charge-back losses can also result from deliberate fraud undertaken by the merchant. For example, a merchant might sell deceptive or misleading merchandise or never deliver the product. Authorization issues, inaccurate or incomplete transaction information, and processing errors can also result in charge-backs. Charge-backs are governed by a complex set of rules and time limits that can be costly to merchants and acquiring banks if disregarded. Charge-back losses realized by the bank are listed as other non-interest expense on the Call Report.

The most effective preventive measure against charge-back losses is thorough underwriting prior to merchant acceptance. Nonetheless, examiners should expect that an acquiring bank have strong controls in place to accurately and timely process charge-backs and retrieval requests. The bank may lose a charge-back dispute (thus resulting in a loss) if it does not adhere to charge-back rules. The absence of effective charge-back monitoring to identify problem merchants for remedial action normally draws examiner attention. Quickly considering problem merchants for termination may help avoid or limit loss.

Charge-Back Transaction Flow

Cardholders initiate charge-backs, for instance when they are dissatisfied with the product, did not receive the merchandise or service, or did not authorize the charge. A consumer first tries to resolve the dispute with the merchant. If unsuccessful, the consumer informs the issuing bank about the dispute, and the issuing bank posts a temporary credit to the cardholder's account. The issuing bank then requests documentation from the merchant to authenticate the transaction and possibly resolve the dispute. If the dispute is upheld, the amount is charged back to the merchant's account and the consumer does not pay for the disputed charge. The consumer has 60 days from the day he or she receives the statement to report a dispute to the issuing bank.

Issuing banks can also initiate charge-backs when the merchant does not follow proper card acceptance and authorization procedures or when there is a problem with the credit card account (for example, it is not valid or has been terminated). The acquiring bank's contingent charge-back liability generally spans 90 to 120 days (but up to 180 days for certain transactions).

Associations have strict charge-back processing regulations. For example, charge-backs occur when a merchant fails to provide copies of requested sales tickets. If the merchant does not fulfill retrieval requests within prescribed time frames, it loses the charge-back dispute. Merchants must also follow other card acceptance procedures, including obtaining authorizations, as depicted in the governing documents.

Charge-Back Monitoring

The Associations notify acquiring banks about high charge-back merchants. Once management has received notification of excessive charge-back activity, examiners should expect management to promptly take appropriate steps to bring charge-back rates down to acceptable levels. The steps may include, but are not limited to, reviewing procedures with merchants or developing a detailed and comprehensive charge-back reduction plan. If the charge-back volume is not sufficiently reduced within established timeframes, the Associations may impose substantial fines against the acquiring bank.

Although the Associations notify acquiring banks about merchants with excessive levels of charge-backs, examiners normally have concern when an acquiring bank's own risk management practices do not detect such merchants or when charge-back processing staff is not alert for merchants with excessive retrieval requests or charge-backs. Numerous charge-backs could indicate an unscrupulous merchant or a need for additional training.

Risk Mitigation for Charge-Backs

Acquiring banks often establish specific merchant reserve accounts, or holdback reserves, for higher-risk or high-charge-back merchants. Holdback reserves are also used to limit a bank's credit risk when the merchant's product or service involves future/delayed delivery. They are funded by a lump sum payment or by withholding part of each day's proceeds. Examiner should expect these types of specific reserve accounts to be adequately funded.

The acquiring bank might also fund a general allowance account, similar to the ALLL (although not commingled therewith), for a portfolio of merchant accounts. The method used to determine the allowance allocation varies but is typically based on contingent charge-back exposure for the entire portfolio. Such an allowance is reported as an "other liability." Examiners should analyze management's merchant reserving methods to determine whether these types of allowances are sufficiently funded.

An acquiring bank might also obtain merchant charge-back insurance which is intended to provide protection against uncollectible charge-backs. While insurance products potentially provide some level of protection, they are not a substitute for strong risk management practices. Insurance contracts frequently include significant limitations or restricting clauses that constrain the usefulness of the contract in the event of an actual loss (for instance, limits on types of losses covered and restrictions based upon bank management's action or inaction in managing the merchant portfolio). In addition, the insurance carrier might not have the financial ability to fund the contract in the event of significant loss.

Larger merchant processors employ collectors to recover charge-back losses and other fees. A collector seeks remedy from the principals of the business through negotiations or civil action.

Accounting for Charge-Backs

Management is expected to appropriately detail charge-back losses on Call Reports as other non-interest expense and reverse any uncollectible fees from income in a timely manner. Any collected funds are to be reported as other non-interest income.

ACQUIRING RENT-A-BINS

A BIN[18] is a number assigned by an Association to identify the bank for authorization, clearing, settlement, card issuing, or other processes. Ownership and usage of BINs can result in significant credit risk exposure if not appropriately controlled, especially when the acquiring bank owns a BIN and permits other entities to share in the usage, otherwise known as an acquiring Rent-a-BIN. The concept of Rent-a-BINs (RAB) was introduced earlier in this manual. There are

[18] An ICA number, which is similar to a Visa BIN, is assigned by MasterCard. ICAs and BINs are collectively referred to as BINs in this manual. Examiners may also encounter arrangements with American Express and Discover, particularly now that their access to banks has expanded.

issuing RABs and acquiring RABs. Issuing RABs were the focus of the Credit Card Issuing Rent-a-BINs chapter while acquiring RABs are discussed here.

Acquiring RABs draw their names from the characteristic of acquiring merchant contracts and cardholder transactions. Under an acquiring RAB arrangement, an acquiring bank permits ISO/MSPs to use the bank's BIN(s) to acquire merchants and settle their credit card transactions. The ISO/MSP retains the majority of income, and the BIN-owner receives a fee for the use of its BIN(s). Although it has minimal operational involvement, the BIN-owner has primary responsibility to the Association if any user fails to perform. The BIN-owner retains the risk of loss as well as responsibility for settlement with the Associations consistent with the contract between the bank and the Association. Thus, examiners should insist that management rigorously oversee and control acquiring RAB arrangements to ensure that the ISO/MSP is appropriately managing the risks. Oversight controls are important, even if the ISO/MSP shares liability with the bank. A failure by management to consider any lending relationships the bank has with ISO/MSPs in analyzing total risk exposure warrants examiner attention. Given the substantial risk involved, many banks are reluctant to enter into acquiring RAB arrangements.

Risk also exists when an acquiring bank uses a BIN owned by another bank. If the BIN-owning bank fails to perform, the Associations may hold all of the BIN-users liable. RABs require close examiner analysis of the acquiring bank's program to determine the extent of risk to the bank.

THIRD PARTIES

The success of a payment system depends on the credit quality of its participants and its operational reliability. As mentioned, the presence of third parties coupled with the bank's ability to sub-license the entire merchant program, or part thereof, to other entities, introduces numerous complexities in the transaction and funds flows related to credit card transactions. Third parties such as ISO/MSPs and servicers are used by acquiring banks for a variety of functions like soliciting merchants, merchant application processing, charge-back processing, fraud detection, customer service, accounting services, selling/leasing electronic terminals to merchants, transaction processing, authorizations, and data capture. Each acquiring bank's program is unique regarding the number of third parties used and the services provided. Examiners should require that banks have proper risk management policies and procedures to control the applicable third-party risks.

An acquiring bank, as the Association member, is ultimately responsible for the settlement of transactions processed through its BINs, regardless of the third parties used and the contents of its contracts with those parties. The acquiring bank (BIN-owner) needs to take an active role in ensuring the quality and integrity of the services these third parties provide because the quality of services among third parties varies greatly. Examiners should pay close attention to instances in which the bank relies on the guarantee of a third party against losses as a substitute for prudent risk management. Losses associated with high-risk or fraudulent credit card activity can be substantial and easily reach figures well beyond the means of a seemingly financially capable third party. Banks have incurred significant losses from failing to control third-party activities. Uncontrolled growth, fraud, and inadequate operations by the third parties have all resulted in significant problems for banks. ISO/MSPs in particular could be motivated by their own profits at the expense of merchant portfolio quality and often have limited financial capacity.

Regardless of the third parties used and any guarantees provided, the examination approach requires that bank staff have the expertise and knowledge of the business to properly manage the risks and that management have a sound plan for managing its merchant program as well as policies and procedures in place to control the risks associated with using third parties and to properly limit the use of the bank's BINs by others. For instance, the final review of merchant applications and the decision to approve or decline a new account should be controlled by the BIN-owner.

The examination should verify that the bank's policies and procedures, in general, provide for:

- A due diligence process to: determine the third party's character and ability to perform the services; assess the risks associated with using the third party; and establish risk controls.
- A process for ensuring the adequacy of written agreements.
- A monitoring process for the third party's operations and financial condition.

Examiners should look for evidence that due diligence processes, in general, include:

- Determining that the third party has the operational and financial ability as well as expertise to perform the services.
- Performing thorough background checks on the third party's principals and key individuals to determine their good standing, including bank and trade references, credit reports, and, where appropriate, criminal backgrounds.
- Analyzing the financial capacity of the third party and its principals to determine continued viability and capacity to absorb losses.
- Performing an on-site inspection.
- Assessing the third party's marketing practices and the types of merchants targeted.
- Assessing the risks associated with the use of the third party and the controls needed to manage the risk (for example, underwriting standards, security of sensitive information, reporting requirements, and procedures for settlement, charge-back processing, fraud monitoring, and pricing).
- Establishing criteria for requiring additional loss controls, such as reserves or security deposits to absorb losses stemming from merchant fraud and charge-backs.
- Ensuring separation of duties for activities performed (for example, the individual conducting the on-site inspection should have no financial interest in its outcome).
- Registering third parties with Associations as required.

The examination should also include assessing whether the bank's monitoring process, in general, includes:

- Periodically reviewing the financial condition of third parties and their principals to determine capacity to meet commitments and remain in good standing.
- Reviewing allowances to ensure they are consistent with the condition of the third party and volume of business generated.
- Reviewing compliance with the bank's established requirements (for example, underwriting standards, settlement and charge-back processing, fraud monitoring, merchant pricing, and security of cardholder information).
- Periodically conducting on-site inspections.
- Periodically evaluating the third party's internal controls (for example, through review of operational audits).
- Assessing system audits for third parties performing processing tasks.
- Periodically reviewing marketing practices.
- Reviewing contingency plans to assure continuity of operations.
- Documenting the bank's relationship with the third party.
- Checking compliance with contractual provisions.
- Determining the adequacy of the bank's controls over third party access to sensitive information.

Contractual Considerations

Concerns arise when management has not obtained a signed, written agreement between it and each third party or when the agreement fails to take into consideration business requirements, key risk factors identified during the due diligence process, and the Associations' regulations. Legal counsel familiar with merchant processing normally reviews contracts prior to signing.

Contractual considerations generally include:

- Responsibilities of each party.
- Terms specifying compensation, payment arrangements, price changes, and time frames.
- Provisions prohibiting the third party from assigning the agreement to any other party.
- Frequency and means of communication and monitoring activities of each party.
- Provisions regarding the ownership, confidentiality, and non-disclosure of cardholder information as well as compliance with cardholder information security standards.
- Recordkeeping requirements and whether each party has access to these records.
- Responsibility for audits, the bank's access to those audits, and whether the acquiring bank has the right to perform an audit of the third party.
- Notification requirements of system changes that could affect procedures and reports.
- Type and frequency of financial information the third party will provide.
- Termination parameters, including potential penalty provisions.
- Maintenance of an adequate contingency plan by the third party.

Additional contractual considerations for ISO/MSPs generally include:

- Tying compensation to the merchant portfolio's performance (for instance, charge-back activity).
- Defining responsibilities for fraud and charge-back processing and losses.
- Requiring security deposits from the ISO/MSP, particularly if its financial condition is weak or the quality of the merchants it solicits presents significant risk.
- Establishing remedies to protect the bank if the ISO/MSP fails to perform (for example, indemnity provisions, early termination rights, and delayed payment).
- Providing criteria for acceptability of merchants.
- Specifying that the bank owns the merchant relationships.
- Controlling the future use and solicitation of merchants.
- Defining the allowable use of the name and logo of the bank and the ISO/MSP.
- Permitting bank employees to conduct onsite inspections of the ISO/MSP.
- Specifying that all applicable regulations and Association rules are to be followed.

Association Requirements Regarding Third Parties

The bank's risk management program needs to consider the Associations' requirements regarding third parties. Each acquiring bank is expected to register third parties according to the Associations' guidelines before accepting services. Associations generally require an initial registration fee and annual fees for each third party under contract. The fees are normally passed on to the third party.

The Associations have specific guidelines relating to contract provisions, functions controlled by the acquiring bank, accessibility of procedural audits, and recordkeeping requirements. In particular, Association regulations state that:

- All new merchant accounts should be reviewed with final approval controlled by the acquiring bank.
- A registered third party cannot subcontract its bankcard-related services to another business. Bankcard-related services can only be provided by businesses with a direct written contract with an Association member.
- All aspects of a member's relationship with a third party should be documented.
- Members are responsible for ensuring that merchants receive payment for the card transactions deposited.

Even after registration, the acquiring bank remains responsible for ensuring compliance with the Associations' operating regulations. The regulations make the acquiring bank liable to the Associations for the actions of third parties. Banks are to periodically submit certain information on third parties used to the Associations and can be fined by the Associations for not doing so.

Agent Banks

Agent banks contract with merchants on behalf of an acquiring bank. Agent banks are typically community banks that want to offer merchant processing services to their merchant customers but that do not have the management expertise and/or do not want to invest in the infrastructure needed to serve as an acquiring bank. Acquiring banks generally provide backroom operations to the agent bank. Depending upon the contractual arrangement, the agent bank may or may not be liable to the acquiring bank in the event of charge-back or fraud losses. Agent banks with liability typically perform merchant underwriting. Agent banks without liability are typically called referral banks. In a referral arrangement, the acquiring bank performs the underwriting, executes the merchant agreement, and accepts responsibility for merchant losses. Acquiring banks sometimes compensate the referral bank byway of a referral fee.

If examining an agent bank, examiners should determine whether management fully understands the bank's financial liability for charge-backs as well as its responsibilities under the agreement with the acquiring bank. An agent bank should have appropriate procedures in place to ensure it fulfills its obligations under such agreement. Examiners should expect that agent banks with liability have proper risk management policies and controls in place for merchant underwriting and monitoring, pricing and profitability, and third-party relationships.

Examiners should determine whether management of an agent bank has ensured underwriting guidelines meet the acquiring bank's underwriting standards, at a minimum, and represent an appropriate level of risk for the agent bank to hold. Acquiring banks may decline a merchant if it poses undue risk or does not meet the bank's minimum standards. Other agent bank tasks include performing ongoing monitoring of sales, charge-backs, and fraud.

Examiners should look for evidence that pricing of agent relationships is sufficient to cover costs, including any fees paid to the acquiring bank and anticipated losses. Depending on the size of the agent bank's merchant portfolio, separate profitability reports on this business line may not be necessary. But, that does not negate management's responsibility to determine if the service is profitable to the bank. If profits are minimal or nonexistent, considerations would include whether the risk is sufficiently offset by the intangible benefits gained from offering the services.

Examiners should expect to see a written agreement clearly outlines both agent and acquiring banks' responsibilities. They should also determine whether the agent bank has performed appropriate due diligence regarding the acquiring bank's ability to meet its obligations under the contract and, similarly, whether acquiring banks have put appropriate controls in place regarding the use of agent banks. Examiners should evaluate controls for maintaining appropriate underwriting standards and processing volumes and for monitoring the agent's financial condition and processing volume. Instances in which the financial condition is not consistent with its merchant portfolio risk profile and/or the activity's volume normally raise concern.

Loans to Third-Party Organizations

Examiners should pay attention to situations in which management has failed to fully understand the total risk exposure when lending to third parties that perform services for the bank, including for its merchant program. The lending relationship creates a potential conflict of interest and increases the bank's overall credit risk. The risk exposure is not only the loan(s) to the third-party but also the contingent liability from merchant processing activities by the third party conducted through the bank's BIN. Lending to a third-party organization sometimes results in management failing to take appropriate action against the third party when problems are identified. For example, management may not want to stop processing for the ISO/MSP because it may jeopardize repayment of the bank's loan. As a result, management could continue with a problem relationship, which may increase the problems and subsequent losses. Examiners should evaluate management's processes to determine and control total risk exposure.

Contingency Planning

Concerns also surface when acquiring banks have not ensured that third-party processors and network providers have contingency plans in place to continue operations in the event of a disaster. If an ISO/MSP is providing the backroom operations, examiners should confirm whether management has ensured that the ISO/MSP has a proper contingency plan. The examiner should determine management's practices for requesting and reviewing contingency plans. Further, the merchant processing examination should include IT examiners to the extent needed to review the adequacy of the contingency plan as well as the bank's in-house data processing systems for merchant processing.

Cardholder Information

Cases where disclosure of cardholder information is not in accordance with privacy regulations and the Associations' guidelines warrant scrutiny. Inappropriate disclosure to third parties could result in substantial liability to the bank, especially if the third party perpetrates fraud.

Association regulations prohibit an acquiring bank from disclosing cardholder and transaction information to third parties, other than to its agents for the sole purpose of completing a transaction, without the prior written consent of the cardholder's issuing bank and the Association. The Associations' regulations also state that if an acquiring bank discloses the information, the acquiring bank must ensure that its agents and their employees make no further disclosure and treat the information as confidential.

The emphasis of the privacy regulations is on providing customers a notice of the bank's disclosure practices and an opportunity to opt out of the disclosure. The regulations also prohibit the disclosure of certain cardholder information for marketing purposes, with certain exceptions.

CORRSEPONDENCE WITH THE ASSOCIATIONS

Correspondence between Associations and acquiring banks can point to potential problems with a particular merchant, third-party arrangement, or a significant portion of the acquiring bank's merchant portfolio. Of particular concern are acquiring banks that have been required to post collateral to the Associations, that have had limits placed on their activity, or that have been fined. Associations typically take these actions when the acquiring bank has excessive levels of risk in the merchant portfolio. Topics of correspondence include, but are not limited to:

- Periodic reviews performed on the acquiring bank by an Association.
- High-risk merchants.
- Terminated merchants.
- Excessive volumes of charge-backs at the merchant and bank portfolio levels.

- Fraud or other suspect activity at both portfolio levels.
- Risk limits on activity, or collateral requirements, imposed on the acquiring bank due to the level of risk in the acquiring bank's portfolio.
- Capital requirements.
- Third party usage.

Examiners should closely review correspondence between the bank and the Associations. Banks should also have the applicable Association's by-laws, regulations/rules, and other guidance on hand for review if necessary.

SUMMARY OF EXAMINATION GOALS – MERCHANT PROCESSING

Examiners are expected to determine the level of risk posed by the bank's merchant processing activities as well as determine whether management has correctly identified and is sufficiently controlling those risks with a comprehensive risk management program. In general, the examiner's role includes:

- Reviewing the bank's strategic plan to determine how (and if) merchant processing fits into the bank's objectives.
- Evaluating the bank's merchant processing policies, including, but not necessarily limited to, those covering merchant selection, underwriting, and monitoring.
- Reviewing correspondence between the bank and the Associations regarding the bank's merchant processing activities.
- Determining the quality of the bank's merchant portfolio, including the identification of any high-risk merchants.
- Sampling recently approved (such as within the last 90 days) merchant files.
- Identifying the volume of merchant processing transactions, comparing that volume to the bank's capital level, and determining if additional capital support is necessary.
- Reviewing the trends in the volume and aging of charge-backs, and determining what charge-back losses the bank has suffered.
- Gauging management's ongoing review processes for merchant accounts.
- Evaluating acquiring Rent-a-BIN activities.
- Assessing agent-bank programs and determining level of liability under such programs.
- Analyzing pricing practices and models as well as profitability of the merchant program. Also, considering whether merchant relationships are profitable and investigating as necessary (for example, if a significant relationship is not profitable).
- Reviewing budgeting and forecasting processes for merchant processing activities, including assumptions used.
- Reviewing the settlement flow chart and the bank's practices for paying merchants.
- Identifying what third parties the bank uses for its merchant activities and reviewing controls over third-party risks. The analysis should include reviewing governing contracts or agreements for significant relationships.
- Assessing the adequacy of holdbacks or other merchant reserves.
- Inspecting contingency plans, calling on IT specialists as necessary.
- Reviewing routine MIS for the merchant processing program.
- Assessing whether management possess the necessary skill-sets to properly management the program.
- Reviewing fraud detection procedures.
- Reviewing merchant program sections of internal and external audit reports.
- Determining whether any planned changes exist for the merchant operation. If changes are planned, identify how the changes may impact the bank, specifically as related to higher risks that the bank may be taking on.

XX. THIRD-PARTY RELATIONSHIPS

Banks are increasingly looking to third parties as a way to gain a competitive edge, enhance product offerings, and reduce costs. Effective use of third-party relationships also allows banks to diversify assets and revenues, access greater expertise, and devote human resources that are in short supply to core businesses. However, third-party relationships or vendor management issues can significantly increase a bank's risk profile. As such, the use of third parties for credit card operations has and will continue to receive substantial and increasing regulatory attention.

Banks primarily use third parties in their credit card programs in two ways: to franchise the bank's attributes and to perform functions on the bank's behalf. In the first, the bank lends its name (and thus, regulated entity status) to credit card products, services, and activities that are usually predominantly conducted by others. Franchising arrangements can expose the bank to substantial financial loss and damage to its reputation if it fails to maintain adequate oversight over the third party as well as sufficient quality and other controls over the products and services offered through the third parties. Situations in which the products or services offered are accompanied by fees, interest rates, or other terms that cannot be offered by the third party directly warrant close attention. An issuing Rent-a-BIN arrangement is an example of a franchising situation and is discussed in the Credit Card Issuing Rent-a-BINs chapter. While co-branding, affinity, and similar programs are not predominantly conducted by the third party, they can be thought to be of a franchising nature in that they are operated as a business line carrying the bank's name. Brief comments on these types of arrangements are found later in this chapter.

The majority of this chapter, however, focuses on the second type of third-party use, commonly referred to as outsourcing. Outsourcing covers a wide variety of arrangements, including, but not limited to, core information and transaction processing, collections, marketing, and customer call centers. Several of the concepts for managing outsourcing arrangements mirror concepts for managing franchising arrangements.

Whether in a franchising or outsourcing fashion, a bank's use of third parties for credit card program functions does not diminish management's responsibility to ensure that the activities are conducted in a safe and sound manner as well as in compliance with applicable laws and guidance. An absence of adequate policies for managing third-party arrangements, including selection and oversight, is normally cause for concern. Examiners should also normally expect to see that management subjects third-party relationships to the same risk-management, security, privacy, and other consumer-protection policies as if the bank conducted the activities directly.

OUTSOURCING

Contracting with third parties for services typically enables a bank to offer its customers enhanced services without incurring the expenses involved in owning the technology, maintaining an adequate level of human resources to effectively carry out the function, and so forth. Banks can outsource many areas of credit card operations, including all or part of any service, process, or system operation. The examination normally includes an assessment of management's practices for ensuring that outsourcing of significant functions is consistent with the bank's strategic plans and for evaluating third-party proposals against well-developed acceptance criteria, all prior to engaging in outsourcing.

The examination incorporates an identification of any instances where management has not provided for a comprehensive risk-management process for governing third-party relationships. Each bank's risk profile is unique and requires a tailored risk-mitigation approach appropriate for the scale of its particular third-party credit card relationships, the materiality of the risks present, and the ability to manage those risks. Nevertheless, there are certain key components common to well-structured third-party risk-management processes:

- Effective risk assessment and strategic planning to identify the bank's needs and requirements. Management's awareness of the risks associated with outsourcing is a prerequisite to establishing suitable controls over such relationships.
- Proper due diligence to identify and select a third-party.
- Comprehensive, written contracts between the bank and the third party.
- Ongoing oversight of the third party and its activities, including determining whether any changes to the arrangements need to be made or whether the relationship should be discontinued.

Examiners should expect management to:

- Ensure each outsourcing relationship supports the bank's overall requirements and strategic plans.
- Make certain the bank has sufficient expertise to oversee and manage the relationship.
- Evaluate prospective third parties based on the scope and critical nature of service(s) to be outsourced.
- Tailor the third-party monitoring program based on initial and ongoing risk assessments of the outsourced services.
- Notify its primary regulators regarding outsourced relationships, when required.
- Register the third party with the applicable Association(s) when required.

Time and resources that management is expected to devote to managing third-party relationships are based on the risk the particular relationship presents to the bank. For instance, outsourcing a processing function for a small, local credit card portfolio usually requires less oversight than outsourcing processing functions for a large, nationwide program with subprime attributes. Smaller and less complex banks may have less flexibility than larger banks when negotiating for services that meet their specific needs and monitoring the third parties. Regardless, regulators hold each bank responsible for proper oversight of its activities conducted by third parties.

Outsourcing does not reduce the fundamental risks associated with the business lines that use it. For example, risks such as loss of funds, loss of competitive advantage, damaged reputation, and improper disclosure of information persist. Furthermore, the bank remains subject to the possibility of regulatory actions regarding the activities. Because the functions are performed by a third party, the risks may be less obvious than if the functions were conducted inside the bank. Nevertheless, substantial risks and the need for proper controls over those risks exist.

RISK CONSIDERATIONS

As mentioned, risk exists whether the bank performs activities internally or elects to outsource them, and management is responsible for appropriately managing risk in all outsourcing relationships. While some risks may be direct, banks normally also assume bilateral, or transitive, risk when they outsource. Bilateral, or transitive, risk refers to when the risk at the third party causes risk to the bank. For example, if a third party is doing processing work for a bank, an operations disruption at the third party could affect the bank's operations. Because different vendors provide different services, risks differ among relationships.

Common risks with third-party arrangements are operational and transactional risks (sometimes interchangeable terms). Such risks may arise from fraud or error as well as from the inability to deliver products or services, maintain a competitive position, or manage information. They exist in each process involved in the delivery of the bank's products or services. For example, many banks rely on data-processing providers for their credit card programs and any extended interruption or termination of service can disrupt normal operations. However, operational and transactional risks include not only operations and transaction processing (such as data processing), but also areas such as customer service, internal control processes, and capacity and contingency planning. Further, operational and transactional risks can affect other risks such as reputation, strategic, legal, and compliance risks.

A third-party's errors, delays, omissions, and similar events that become public knowledge or directly affect customers can significantly affect the bank's reputation. For example, a third-party's failure to maintain adequate contingency plans and facilities for key processes may impair the bank's ability to provide critical services to its customers. A third-party's use of abusive or problematic marketing or collection techniques can also adversely impact the bank's reputation.

From a strategic perspective, inaccurate information from third parties can cause bank management to make poor strategic decisions. For example, if a third-party improperly represents that it has been effectively collecting receivables, management could make a decision to move more collections activity to that third party or to grow the portfolio. The result of those strategic decisions would be that that bank would be faced with higher credit risk than it believed it would have. Inadequate management experience and expertise can also lead to a lack of understanding and control of key third-party risks.

In addition, outsourced activities that fail to comply with legal or regulatory requirements can subject the bank to a variety of legal and regulatory sanctions. For example, inaccurate or untimely consumer compliance disclosures or unauthorized disclosure of confidential customer information could expose the bank to civil money penalties or litigation. Third parties often agree to comply with banking regulations, but their failure to track regulatory changes could increase compliance risk for the serviced banks. Many of the compliance, legal, and reputation risks arising from third-party arrangements easily translate into safety and soundness risks, similar to what is discussed in the Credit Card Issuing Rent-a-BINs chapter.

Credit risk can also result from third-party relationships. For example, if a bank has outsourced the collections functions for its credit card portfolio, a failure of the third-party collector to employ effective collections efforts could result in continued delinquencies (and thereby potentially strained cash flow and increased liquidity risk) as well as more difficulty eliciting recoveries. Further, a third-party's use of overly liberal collection techniques could inappropriately delay loss, for instance if use of workout programs or re-aging is abused.

The quantity of risk associated with outsourcing depends on the function that is outsourced as well as the third party and its technology, processes, techniques, and materials used. In general, the following items are key considerations when evaluating risk at the inception of an outsourcing decision as well as throughout the arrangement's life:

- Sensitivity of data accessed, protected, or controlled by the third party.
- Volume of transactions, accounts, and receivables.
- Criticality of the outsourced function to the bank's business.
- Strength of the third-party's financial condition.
- Management and employee turnover of the third party.
- The third party's ability to maintain business continuity.
- The third party's capability to provide accurate, relevant, and timely MIS.
- The third party's experience with the function outsourced.
- Reliance on subcontractors.
- Location of the third party, particularly if cross-border (foreign-based third-parties).
- Reliability and security of technology and other resources used.
- Ability to accommodate growth, which should consider outsourcing that the third party may also be providing to other parties in addition to the bank.

Further, third-party environments can foster a hierarchy approach in which the third party provides more attention to its top-volume, top-paying, or other big-name customers. If the bank resides in the lower rungs of the hierarchy, the quality of services received could suffer unless management has put appropriate controls in place.

DUE DILIGENCE

Examiners should determine if management's due diligence processes ensure that the third party meets the bank's needs. Effective due diligence processes normally confirm and assess the following regarding the third party:

- Existence and corporate history.
- Qualifications, backgrounds, and reputations of its principals, including criminal background checks where appropriate.
- References, such as other entities that are using the third party for similar services.
- Financial status.
- Strategy and reputation.
- Service delivery capability, status, and effectiveness.
- Technology and systems architecture.
- Internal control environment, security history, and audit coverage.
- Legal compliance including complaints, litigation, and regulatory actions.
- Reliance on and success in dealing with downstream third parties (that is, subcontractors or when the third party outsources functions to another third party).
- Insurance coverage.
- Comprehensive contingency plans.
- Competent employees as well as a sufficient level of employees and resources.

Seeking out information on intangibles, such as the third party's service philosophies, quality initiatives, and management style, is another critical due diligence element. Concern arises when the third party's culture, values, and business styles do not fit those of the bank.

The depth and formality of due diligence normally varies according to the risk of the prospective outsourced relationship as well as the bank's familiarity with the prospective third party. An appendix of the FFIEC's Outsourcing Technology Services booklet (June 2004) provides considerations when the prospective third party is foreign-based.

CONTRACTS

Examiners should expect a written contract to be present for each third-party relationship, including instances where the third party is affiliated. Because of the importance of the contract, the examination normally includes substantiating whether management:

- Verifies the accuracy of the description of the outsourcing relationship in the contract.
- Ensures the contract is clearly written and contains sufficient detail to define the rights and responsibilities of each party.
- Engages legal counsel to help prepare and review proposed contracts.

Common contract elements include, but are not limited to:

- *Scope of Service* – A description of the rights and responsibilities of the parties involved is a main component of the contract.
- *Performance Standards* - Minimum service or performance level requirements and remedies for failure to meet those standards or requirements are normally identified.

The requirements could become ineffective unless management periodically reviews the standards to ensure they remain consistent with the bank's goals and objectives.

- *Security and Confidentiality* - Security and confidentiality of the bank's resources is critical. A failure of the contract to prohibit the service provider and its agents from using or disclosing the bank's information, except as necessary to or consistent with providing the contracted services, is cause for concern as are situations in which the third party does not report to the bank when security breaches occur, the potential or actual effect of those breaches on the bank, and corrective measures.
- *Audit* - Contract commonly specify the types of audit reports the bank is entitled to receive, audit frequency, any charges for obtaining the audits, and the rights of the bank and its regulatory agencies to obtain the results of the audits in a timely manner. It may also specify rights to obtain documentation of the resolution of any deficiencies and to inspect the facilities and operating practices of the third party.
- *Reports* - The frequency and type of reports (for instance, performance reports and financial statements) that will be provided to the bank are normally specified.
- *Business Resumption and Contingency Plans* – Contract provisions normally address the third-party's responsibilities regarding business resumption and contingency plans. Examiner attention should be drawn to contracts that contain provisions that would excuse the third party from implementing its contingency plans.
- *Sub-Contracting* - Some third parties may contract with other third parties. Examiner attention should be directed to instances where management is not aware of and has not approved subcontractors involved in the bank's credit card program. Notification and approval requirements regarding changes to the third-party's significant subcontractors may be defined in the contract.
- *Pricing* – A full description of the compensation method is normally incorporated. Banks usually have many choices for pricing an outsourcing venture. Examples of different pricing methods include cost plus, fixed price, unit pricing, variable pricing, and incentive-based pricing. Contracts also normally specify guidelines for pricing changes in the future. Pricing that appears excessive in relation to the services provided should be closely inspected.
- *Indemnification* – Most contracts include indemnification provisions that require the third party to hold the bank harmless from liability for the third-party's negligence. The strength of the indemnification in reality is closely tied to the third-party's financial condition, and indemnification provisions are not a substitute for proper risk-management practices.
- *Limitation of Liability* - Some contracts contain clauses that limit the amount of liability that can be incurred by the third party. If the bank considers such a contract, examiners should expect that management has assessed whether the damage limitation bears an adequate relationship to the amount of loss the bank might reasonably experience as a result of the third-party's failure to perform its obligations.
- *Termination* - The timeliness and expense of contract termination provisions are key risk points. The extent and flexibility of termination rights varies depending upon the service outsourced. Examiners should look for considerations such as changes in control, convenience, substantial cost increases, repeated failures to meet service levels, failure to provide critical services, bankruptcy, and company closure.
- *Regulatory Compliance* – Concerns arise when contracts do not include an agreement that the third party and any downstream entities will comply with applicable regulatory guidance and requirements and that the third party will provide regulators with accurate information and timely access based on the type and level of service provided to the bank.

The Associations also have certain contracting expectations for certain third-party arrangements. Examiners may refer to the applicable Association's guidelines when applicable.

Examiners should collect any evidence that management has signed contracts that contain provisions or inducements that may adversely affect the bank. For instance, contract provisions that include prolonged durations, significant increases in costs after the first few years, and/or substantial cancellation penalties could expose the bank to unnecessary risk. In addition, some contracts improperly offer inducements that allow a bank to retain or increase capital by deferring losses on the disposition of assets or avoiding expense recognition. These inducements typically attract banks wanting to mask capital problems.

OVERSIGHT PROGRAM

The degree of oversight and review of outsourced credit card activities depends on how critical the service, process, or system is to the bank. Examiners are tasked with evaluating the bank's oversight program for ensuring third parties deliver the quantity and quality of services required by the contract. To increase monitoring effectiveness, management may periodically rank third-party relationships according to risk to determine which service providers require the greatest level of oversight. Rankings are based on the residual risk of the relationship after analyzing the quantity of risk relative to the controls over those risks. Relationships with higher-risk ratings warrant more frequent and stringent monitoring.

Concern is normally justified when personnel responsible for third-party oversight do not have the necessary expertise to assess the risks and/or do not maintain sufficient documentation of the oversight program. Oversight documentation can be helpful to management when renegotiating contracts and developing contingency planning requirements.

Concern is also normally warranted when management has not incorporated on-going monitoring of the financial condition of the third parties in its oversight program. Effective monitoring usually incorporates management reviewing the financial viability of its third parties no less than annually and reporting the results to the board of directors or a designated committee thereof. However, if the third-party's financial condition is declining or unstable, more frequent financial reviews are often warranted. In addition to annual financial statements, management may also use other forms of information to determine a third party's condition, such as independent auditor reports or information provided by public media (trade magazines, newspapers, and so forth).

Examiners should look for evidence that management has executed its contingency plan if it becomes aware that the third-party's financial condition is unstable or deteriorating. Even if the third party remains in operation, its financial problems may jeopardize the quality of its services and possibly the integrity of the data in its possession. A third-party's failure to provide adequate financial data is normally considered a red flag that there may be serious financial stability issues.

Termination of services due to bankruptcy of the third party can have a devastating effect on the bank's operations, particularly if there is not sufficient advance notice of termination, an effective contingency plan, or adequate access to third-party personnel. In such situations, the bank is put into the position of having to address the situation with little advance notice. While many options might be available, they are frequently costly and may cause harmful operating delays.

CONTINGENCY PLANNING

The bank's contingency plan, normally intended to complement its third-parties' plans, is an essential recovery tool when disruption occurs with minimal advance notice. Concerns arise when the plan does not clearly lay out the specific responsibilities of the parties involved. The supervisory approach includes assessing whether management understands all relevant third-party contingency plans, incorporates those requirements within its own plan, and ensures the third party tests its plan at least annually. If the third party maintains an effective contingency plan, disruption of services may likely be minimal and the contract may remain intact.

With respect to monitoring and maintaining contingency plans, management's duties generally include:

- Regularly reviewing the contingency plans of its third parties to ensure any services considered "mission critical" for the bank could be restored within an acceptable timeframe.
- Reviewing contingency plan testing by the third parties. For critical services, annual or more frequent tests of the contingency plan are expected.

INFORMATION SECURITY / SAFEGUARDING

Examiners will expect that management makes certain that information is adequately protected in outsourcing relationships. Banks have a legal responsibility to ensure third parties take appropriate measures to meet information security and safeguarding guidelines. Appropriate due diligence is usually the first line of defense for ensuring the protection of information and systems. Concerns surface when third parties are given access to the information and systems beyond that necessary to perform the outsourced function.

OUTSOURCING TO FOREIGN SERVICE PROVIDERS

Some banks have outsourcing relationships with third parties located in foreign countries. These arrangements can provide cost, expertise, and other advantages and should be subject to the same due diligence and assessment as domestic relationships. However, foreign outsourcing relationships can result in unique strategic, reputation, credit, liquidity, transactional, geographic, and compliance risks. For instance, foreign third parties that provide transaction processing or customer service could magnify compliance and legal risks. Failures by management to identify, assess, prevent, and control the risks warrant examiner attention. Appendix C of the FFIEC's Outsourcing Technology Services booklet (June 2004) includes an appendix about foreign service providers and the risks encountered in such arrangements. While the booklet is IT-focused, several of its concepts translate to safety and soundness concepts. Additional guidance is housed in FIL-52-2006, *Foreign-Based Third-Party Service Providers: Guidance on Managing Risks in These Outsourcing Relationships.*

OUTSOURCING TO AFFILIATED ENTITIES

When outsourcing to an affiliate is considered, management must assure that the arrangement evidences an arms-length transaction. An arrangement between a bank and an affiliate should be on terms that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with a non-affiliated third party. The costs and quality of services provided should be commensurate with those of a nonaffiliated provider and the arrangement must comply with regulations governing affiliate transactions.

ASSOCIATION REQUIREMENTS

The Associations mainly communicate with their member banks and expect the member banks to convey necessary information to the third parties. In 2004, the Associations began requiring registration for certain third parties used by the member banks. Examiners should determine whether the bank has registered any of the third parties used with the Associations (or has validated Association-registration of the third parties, as applicable) and should gain an understanding of the services provided and responsibilities under registered arrangements. (Nevertheless, examiners must also understand the facets of any unregistered arrangements, namely those of a material nature).

EXAMINATION AND INVESTIGATION OF UNAFFILIATED THIRD-PARTY SERVICERS[19]

Situations occasionally arise where the safety and soundness of an insured depository institution is materially affected by transactions, contracts, or business arrangements with parties that are not affiliated with the institution. When such situations arise, it is necessary for the FDIC to examine the other side of the transaction. The potential impact of these business relationships on the insured depository institution necessitates a complete understanding of the nature of the transaction and relationship and its effect on the insured institution.

By statute, the FDIC has authority to obtain records of unaffiliated service providers and other counterparties relating to an insured financial institution. Such authority is not unqualified but depends on particular facts and circumstances giving rise to inquiries by the FDIC. Several statutory provisions support this conclusion: Sections 10(b) and 10(c) of the FDI Act; Section 7(c) of the BSC Act; and Sections 3(w)(5) and (6) of the FDI Act. The information that the FDIC can obtain from an unaffiliated service provider or other counterparty is not limited to specific transactions with or relating to the insured depository institution but can extend to the financial books and records of the servicer or entity so long as such documents are needed in furtherance of an examination that relates to the affairs of an insured bank.

It is important that examiners are aware of material transactions, service contracts, or other business arrangements that could have a material affect on an insured bank. If it is concluded that information is needed from an unaffiliated service provider or other counterparty to the bank, then the examiner should consult with the Regional Office. The Regional Office will assist the examiner in determining whether information is needed from an unaffiliated service provider, and if so, in obtaining the appropriate information. Examination authority covering bank service corporations is set out in Section 7 of the BSC Act.

AFFINITY, CO-BRANDING, AND CORPORATE CARD ARRANGEMENTS

Affinity, co-branding, and similar arrangements represent forms of third-party arrangements. Examiner attention for these types of programs is normally directed to instances in which management has failed, prior to entering into such arrangement, to analyze the integrity of the third party, to obtain an independent verification of the legitimacy of that entity, to determine the net income expected from the program, and to ascertain the possible effect of high attrition rates should the third party withdraw its endorsement. Because of the possible effect of high attrition rates, examiners should expect the contract to define the length of the relationship as well as renewal and termination procedures. If the relationship is controlled by the third party, that third party could be free to renegotiate card-issuing agreements and take members elsewhere. Examiner attention is also warranted when management is not performing on-going monitoring of the portfolios and programs in these types of arrangements. Monitoring normally includes performance indicators such as, but not limited to, response rates, approval rates, utilization rates, purchase volume, delinquencies, and charge-offs. Examiners should also determine if management has sufficiently reserved for rebate programs, as discussed in the Capital chapter.

[19] The language in this section is taken from the Risk Management Manual of Examination Policies.

RETAIL PARTNERS

Management's review of the financial strength and reputation of the retail partner prior to entering into an agreement is critical to the success of a retail program. Examiners should direct their attention to situations in which management has failed to:

- Maintain documentation and analysis similar to that performed for the bank's commercial borrowers, including the assessment and monitoring of the company's financial condition.
- Consult with legal counsel.
- Establish a contingency plan to deal with bankruptcies.
- Perform ongoing monitoring of the retail portfolios, including performance and quality indicators such as, but not limited to, response rates, approval rates, utilization rates, purchase volume, delinquencies, and charge-offs.

Management's failure to properly provide for these risk-mitigating measures could elevate asset quality problems arising from the failure of a retail partner.

SUMMARY OF EXAMINATION GOALS – THIRD-PARTY RELATIONSHIPS

Examiners are expected to evaluate the quality of risk-management processes used to manage the bank's third-party relationships. As part of their role, examiners should:

- Review policies regarding third-party relationships.
- Assess the level of risk present in outsourcing arrangements, which may include reviewing management's internal risk-ranking processes or risk assessments.
- Evaluate the overall outsourcing process for appropriateness given the size and complexity of the institution as well as the nature of the credit card programs affected.
- Evaluate the third-party selection process, including determining whether due diligence requirements encompass all material aspects of the prospective relationship.
- Evaluate the contracting process.
- Evaluate the bank's process for on-going monitoring of the relationship.

GLOSSARY

Account Number	The unique sequence of numbers given to a cardholder's credit card account and that is embossed on the face of the credit card.
Account Testing	A fraud scam in which criminals verify whether a credit card account number is valid. The perpetrators submit an authorization request but not a sales draft. If the account is valid, it is then used for larger fraudulent transactions. Examiners should be cognizant that the term "account testing" is also commonly used to refer to transaction testing of cardholder accounts during the examination process and is separate and distinct from account testing as used to refer to the fraud perpetration discussed above.
Acquiring Bank	A bank that contracts with merchants to accept, process, and settle credit card transactions. The acquiring bank is the entity that maintains the merchant relationships and collects cardholder transaction data from those merchants (either directly or via a third party). It then initiates that data into an interchange system, subsequently receives payment from the issuer, and pays the merchants. Acquiring banks typically provide charge-back processing and other back-office services and are also known as acquirers or merchant banks.
Adverse Retention	The phenomenon in which the bank inadvertently retains a disproportionately high number of potentially bad accounts (for example, unprofitable or overly problematic accounts).
Adverse Selection	The phenomenon in which a disproportionately high number of potentially bad credit risks respond to an offer.
Affinity Cards	General purpose credit cards offered by two organizations: one the lender and the other usually a non-financial group. The issuer often donates a portion of the fees or charges (sometimes referred to as a royalty) to the non-financial group. Use of the card often entitles the cardholder to special discounts or deals from the non-financial group.
Agents	Entities that source merchants or cardholders, serve as a gateway, or provide other services for the bank.
Agent Bank	A bank that, by agreement with an acquirer, participates in that acquirer's merchant processing program. It may or may not be liable to the acquirer for losses incurred on its merchant accounts.
Annual Percentage Rate (APR)	The cost of credit at a yearly rate. It is calculated in a standard way, taking the average compound interest rate over the term of the loan so borrowers can compare loans. Lenders are required by law to disclose a card account's APR.
Applicants	People/businesses that respond to an offer for or request credit (they typically fill out an application).

Applications	Forms filled out by a consumer or business requesting credit. The form asks for various identifying information as well as credit-related information on which the lender, in part, bases its credit decision.
Associations	The organizations (VISA and MasterCard) that provide rules, advertising, and settlement services and that promote the card brand for their member financial institutions. Banks must be a member to offer the applicable Association's credit card services. Membership rights and obligations are specifically defined by the Associations.
Attributes	Possible answers to questions asked about the applicant on an application or items of information taken from the credit bureau report.
Attrition	The loss of accounts either involuntarily through charge-offs, or death; or voluntarily, at the option or request of the cardholder.
Authorization	The process of obtaining permission from the issuing bank to accept the card for payment. Authorization entails assessing the card's transaction risk and reserving the specified amount of credit on the cardholder's account if approved. If a merchant does not comply with Association rules regarding authorizations, payment to the merchant may be withheld or a subsequent charge-back may occur. Authorization processes vary between merchant types.
Automated Teller Machine (ATM)	An unattended, self-service electronic machine that enables consumers to withdraw paper money or conduct other banking procedures upon insertion of an encoded plastic card, such as a debit or credit card, and entry of a personal identification number (PIN).
Available Credit	The amount of unused credit on an account that is accessible for cardholder transactions. Generally it is the credit line amount less the outstanding balance less pending authorizations (holds). It is sometimes referred to as the "open-to-buy."
Backroom Operations	The operational functions that are performed by the acquirer or issuer to facilitate the day-to-day processing of credit card transactions.
Balance Transfer	The process of moving an unpaid credit card debt from one issuer to another.
Bank Identification Number (BIN)	A series of numbers assigned by Visa to its member financial institutions to identify each institution for acquiring and issuing processes. The term ICA is used by MasterCard and is similar to a BIN. VISA BINs start with 4, and MasterCard ICAs start with 5.
Behavior Scores	Results of statistical scoring systems that are often used to increase collection efficiency and decrease collection costs. The system is usually based on internally-derived information about the consumer's behavior, such as payment history, card usage patterns, and so forth.
Billing Cycle	The time (number of days) between billing statements. It is the period between the previous statement date and the current statement date during which both credit and debit transactions are accumulated for billing, usually about 30 days.

Billing Statement	The bill (printed record) sent by a card issuer to the customer. It is usually sent monthly and includes, but is not limited to, itemization of activity on the account, including balance, purchases, payments, credits, finance charges, and other account activity.
Blogging	Blog is an abbreviated term for weblog, which is an online journal that is frequently updated for general public consumption.
Bust-Out Scams	Cons in which a seemingly legitimate merchant opens a valid account with an acquirer and, after a brief period of normal sales activity, deposits a large number or high dollar amount of fraudulent transactions. Once payment for the transactions is received, the merchant empties its deposit account and disappears. Merchants in bust-out scams often make applications to several acquirers at the same time.
Calibration	The process by which a model's output is converted into the actual rate of the outcome and includes adjusting or modifying for the difference between the expected rate based on the historical database and the actual rate observed.
Card Processor	A party that provides transaction processing and other services for an issuing bank or an acquiring bank. It is an Association member, or an Association-approved non-member acting as the agent of a member, that provides authorization, clearing, or settlement services for merchants and members. Some banks act as their own card processors while other banks use third parties for card processing (there are card-issuer processors and card-merchant processors, and some third parties are both).
Card Utility	The level of a card's practical usefulness to consume a commodity, product, or service.
Cardholder	A person to whom a card has been issued.
Cardholder Agreement	A written, legal contract between the issuer and the cardholder. It contains the terms of the account and a schedule of various fees.
Cash Advances	Using a credit card to obtain cash (as compared to making a purchase or consuming a service), for instance by using an ATM or a bank branch. There is normally a fee associated with cash advances.
CEBA Bank	The term CEBA comes from the enactment of the Competitive Equality Banking Act of 1987 (CEBA) which established conditions for special-purpose credit card banks. A CEBA bank is a special kind of issuing bank. It may only accept time and savings deposits of $100M or more. It is often affiliated with a retailer and offers private label cards for use at the affiliated organization. It may, however, issue general purpose VISA or MasterCard accounts.
Champion/Challenger Strategies	Approaches developed to test alternatives (challengers) against an existing strategy (champion).

Characteristics Questions asked on an application, or an informational category on the consumer's credit bureau report.

Charge-Backs A transaction that is returned as a financial liability by the issuer and/or the cardholder to the acquirer and most often to the merchant for resolution after the sale has been settled. It is generated when a cardholder disputes a transaction or when the merchant does not follow proper card acceptance procedures. The issuer and acquirer research the facts to determine which party is responsible for the transaction, and strict Association rules must be followed. If the charge-back is upheld and the merchant cannot or does not cover it, the acquirer must cover it.

Charge Card A card product with a line of credit that does not revolve (that is, the balance must be paid off each billing period (typically each month)).

Charge-Off The removal of an account from a creditor's books as an asset. This usually results from delinquency, death, bankruptcy, or similar circumstances. While it indicates that the creditor does not expect the debt to be repaid, it does not mean that the debt no longer exists (that is, the cardholder still owes the debt) or that there will not be further attempts to collect it.

Clearance The process of transmitting, reconciling, and, in some cases, confirming payment orders prior to settlement.

Co-Branded Card A type of card issued through a partnership between a bank and a retail company, such as a large department store. Usually, the attraction of the card is special deals with the retailer or rebates. The intent is to promote the retailer's product and increase the bank's receivables.

Consumer Credit Counseling Service (CCCS) A non-profit organization with professional financial counselors who help consumers find a way to repay their debts by using budgeting and funds management processes.

Consumer Reporting Agencies Companies that collect and sell vital information about how consumers handle credit. Each issues a credit report that details how the consumer manages his or her debts and makes payments, how much untapped credit the consumer has available, whether the consumer has applied for any loans, whether any financial matters of public record exist, and so forth. Reports are made available to the individuals and to creditors who profess to have a legitimate, permissible purpose to inquire about the creditworthiness of the consumer. The three major consumer reporting agencies in the United States are Equifax, Experian, and Trans Union. Consumer reporting agencies are commonly known as credit bureaus.

Convenience Checks Instruments that are used like a personal check but that are linked to the consumer's credit card account. They are checks drawn on the issuing institution for the purpose of transferring account balances from another financial institution or for transactional purposes.

Convenience Users Cardholders who pay their balance in full on or before each payment due date. This type of user is often referred to a transactor.

Credit Bureau	A company that collects and sells information about how consumers handle credit. It issues a credit report that details how the consumer manages his or her debts and makes payments, how much untapped credit the consumer has available, whether the consumer has applied for any loans, whether any financial matters of public record exist, and so forth. Reports are made available to the individuals and to creditors who profess to have a legitimate need for the information. The three major bureaus are Equifax, Experian, and Trans Union. A credit bureau is also known as a consumer reporting agency.
Credit-Enhancing Interest-Only Strips	On-balance sheet assets that, in form or in substance, (1) represent the contractual right to receive some or all of the interest due on transferred assets and (2) expose the bank to credit risk that exceeds its pro-rata claim on the underlying assets whether through subordination provisions or other credit-enhancing techniques.
Credit-Enhancing Representations and Warranties	Contractual obligations that are designed to insulate investors from credit risk generally through mechanisms other than redirecting internal cash flows. Examples include guarantees and surety bonds.
Credit Enhancement	Various internal and external facilities designed to reduce the credit risk to the investors with the goals of achieving higher ratings on, and improving the marketability of, investor certificates.
Credit History	A record of a person's credit profile including debt payments and other relevant financial information such as collections and public records. It is a compilation of a consumer's use and pay-back of credit.
Credit Limits	The dollar amount assigned to an account as the ceiling of credit disclosed to the consumer that the consumer is approved to borrow.
Credit Report	A full history of information within a consumer's credit file at the credit bureau that includes identification information, current and historical account performance, collection activity, public records (bankruptcy, tax liens, and so forth), and records of other credit inquiries.
Credit Score	The result of a calculation based on a consumer's credit history that is intended to predict future credit performance for that consumer. It is a numerical estimation of the likelihood that the consumer will meet his or her debt obligation(s).
Debit Cards	Cards issued to pay for goods and services or to make transactions at an Automated Teller Machine and for which the cardholder is accessing funds from a personal checking or savings account rather than drawing on credit. As such, they are a "pay-as-you-go" function (compared to credit cards, which are a "pay later" function).
Delinquency Bucket	A compartment (usually for reporting purposes) that is identified by a delinquency (past due) stage (for example, 1 to 29 days past due, 30 to 59 days past due, and so forth).

Direct Credit Substitutes	Direct credit substitutes arise from an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance sheet asset or exposure that was not previously owned by the bank (that is, it was a third-party asset), and the risk assumed exceeds the pro-rata share of the bank's interest in the third-party asset. Examples of direct credit substitutes include purchasing a subordinated certificate of another bank's securitization, guaranteeing a mezzanine certificate of another bank's securitization, or providing a letter of credit to an asset-backed commercial paper program.
Discount Rate	The fee, as a percent of sales volume, an acquirer charges a merchant for processing sales transactions. This is also referred to as the merchant discount. Examiners must be cognizant that the term "discount rate" is used in banking for other purposes as well (for instance, when referring to a certain borrowing rate from the Federal Reserve Bank).
Dual-branding	An arrangement in which the payment card offered carries two card brands (for example, Visa and American Express, MasterCard and Diners Club, and so forth).
Early Amortization	In a securitization, an unplanned liquidation of the assets usually due to deterioration in the credit quality of the underlying receivables. Another term for "Wind Down Event."
Economic Capital	Economic capital is a measure of risk, not of capital held, and is regardless of the existence of assets. Economic capital model results are expressed as a dollar level.
Electronic Benefits Transfer (EBT)	The electronic delivery of government benefits using plastic cards.
Electronic Data Capture (EDC)	The process when the merchant swipes the credit card through an electronic card reader or terminal. The information (data) on the card's magnetic stripe is entered into (captured in) the processor's database electronically, hence the term electronic data capture.
Estimated Managed Assets	Average assets on the bank's general ledger plus all outstanding assets (in this case, credit card receivables) securitized as of a specific date.
Exceptions	Items or occurrences that are outside of the bank's policy guidelines or that do not fit the established rules or judgment criteria.
Excess Spread	Portfolio yield minus investor coupon, servicing fee, charge-offs (net of recoveries), and any other securitization trust expenses expresses as a percentage of the total outstanding receivables securitized (and allocated to the investor certificates).
Factoring	A form of fraud where a merchant creates false sales transactions, inflates the sales amount, or alters the sales drafts to improperly receive funds from the issuer. The merchant's intentions could be to obtain additional money to cover charge-backs or cash flow problems, or to cease operations and disappear with the sales proceeds. The acquirer

is then responsible for any remaining charge-backs.

Fedwire — The Federal Reserve Bank's (FRB) nationwide, real-time gross settlement electronic funds and securities transfer network. It is a credit transfer system. Each funds transfer is settled individually against an institution's reserve or clearing account on the books of the Federal Reserve. The issuing bank pays the Associations using Fedwire. To use Fedwire, a bank must hold an account at the FRB and settlement is drawn from the account. The issuing bank makes the payment by sending a message over Fedwire that authorizes the FRB to electronically debit the bank's FRB account for the net settlement amount and transfer the funds to the settlement bank. The transfers are essentially instantaneous. The settlement bank then pays the merchant bank using Fedwire.

Finance Charges — Charges for using a credit card and that are comprised of interest costs and other fees.

First Payment Default — When a new cardholder fails to make the first payment due in a timely manner.

Floor Limit — A per-transaction amount above which authorization is required. It is a dollar amount set by the acquirer, in accordance with Association rules, above which the merchant must obtain authorization. There are normally two types of floor limits: (1) a standard floor limit where transactions above the limit require an authorization request and which varies by merchant type and (2) zero-floor limits where all transaction amounts require an authorization request.

Future/Delayed Delivery — Sales transactions associated with conveyance of the products or services sometime after the date of purchase (that is, in the future). Examples include airline tickets, concert tickets, and travel/tour packages.

Grace Period — The grace period is the interest-free period of time allowed by a lender. The standard grace period is usually between 20 and 30 days. If there is no grace period, finance charges start accruing the moment a purchase is made with the credit card. Consumers who carry a balance on their credit cards generally do not have a grace period for those cards (meaning that finance charges are accrued from the date of the charge, not from the end of the finance charge grace period).

High-Side Override — Declining credit to an applicant that scores above the cut-off score.

Holdback — A certain percentage of the merchant's sales deposits is held-back (retained) by the acquirer to serve as a reserve against future charge-back exposure or to cover existing charge-backs.

Impaired — Impairment occurs when, based on current information and events, a bank will likely be unable to collect all amounts (principal and interest) according to the contractual terms of the original loan agreement.

Independent Sales Organization (ISO)	An organization or individual that is not an Association member but that has a bankcard relationship with an Association member that involves acquiring or issuing functions such as the ISO soliciting merchant accounts, arranging for terminal purchases or leases, providing customer service, and soliciting cardholders. An ISO is sometimes referred to as a Member Service Provider (MSP), although their definitions are not always synonymous. The acquirer must register all ISO/MSPs with the applicable Association.
Interchange	The exchange of transaction data, information, and money between acquiring and issuing institutions participating in a payment network and in accordance with the Associations' by-laws and rules. It is the electronic infrastructure that processes financial and non-financial transactions between financial institutions.
Interchange Fees	Fees paid by one bank to another to cover handling costs and credit risk in a card transaction. Also referred to as the interchange rate, it is usually a percentage of the transaction amount and is derived from a formula that takes into account authorization costs, fraud and credit losses, and the average bank cost of funds. The interchange fee is typically set by the Associations. It is normally extracted from the merchant discount by the acquiring bank and paid to the separate issuing bank to compensate it between the time of settlement with the acquiring bank and the time of recouping value (payment) from the cardholder.
Introductory Rates	Short-term, temporary interest rates that are also known as a promotional rates or teaser rates.
Issuers	Financial institutions that supply (issue) cards to cardholders for use in performing transactions. They hold and maintain the cardholder relationship.
Laundering	A form of merchant fraud that occurs when a merchant submits drafts for another merchant. The merchant account holder typically is compensated for submitting the unauthorized merchant's business by receiving a percentage of their sales volume. Laundering is a federal offense. In addition, several states' criminal statutes and Association operating regulations prohibit laundering.
Layering	The inappropriate practice of recording more than one amount for the same probable loan loss in the allowance.
Lockbox	A deposit mechanism used by entities to facilitate their deposit transaction volume. Typically, commercial firms and businesses direct customers to send payments directly to a financial institution address or a post office box controlled by the institution. Financial institution personnel record the payments received and prepare deposit slips. Subsequent processing proceeds as with other deposit taking activities.
Loss Contingency	An existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur.

Loss Seasoning Curves	A term used to describe the normal migration of losses on accounts as they age. This curve assumes losses remain minimal from origination to a few months after origination, steadily increase in volume, and then eventually level off. The loss seasoning curve varies between products, such as between prime and subprime products.
Low-Side Override	Approving credit to an applicant that scores below the cut-off score.
MATCH	Short name for Member Alert To Control High Risk Merchants. A national database of merchants and their principals that have been terminated for cause or that have made multiple applications for merchant accounts. The file is maintained by the Associations based on information reported by acquirers.
Member Service Providers (MSP)	In general, entities or individuals that are not Association members but are registered with the Association to provide card program services to a member.
Merchants	Sellers of goods, services, and/or other information who accept credit cards as payment for these items. They have signed a merchant agreement to honor credit cards and display the service mark (logo).
Merchant Category Codes (MCC)	Universal, four-digit numbers that are assigned by the acquiring bank and identify a merchant by its primary line of business. There are several hundred MCCs used.
Merchant Processing	The routing of electronic transmissions from merchants through the payment network for clearing and settlement. It is a separate and distinct business line from credit card issuing. Merchant processing activity is, for the most part, off-balance sheet and involves gathering sales information from the merchant, collecting funds from the issuing bank, and paying the merchant. Various third parties may be involved.
Migration Analysis	A common method used by management to evaluate the adequacy of allowances for loan losses. It segregates the credit card portfolio into delinquency buckets in order to determine the amount of receivables that roll through each delinquency bucket and progress to charge-off.
Minimum Payment	The smallest amount a cardholder can pay to meet the terms of the account agreement and keep the account from going into default.
Monoline Credit Card Banks	Banks that mainly focus on the business of credit cards and don’t have significant other banking operations.
Negative Amortization	The phenomena in which the cardholder’s account balance grows (excluding purchase activity) despite the cardholder making the minimum payment as agreed to in the cardholder agreement.
Over-Limit	When the account’s balance is beyond its credit limit. One or any combination of purchases, cash advances, fees, and finance charges could cause an account to become over-limit.

Override	Decisions that are contrary to the decisions recommended by the scorecard or by the usual, approved judgmental evaluation process.
Paper-Based Transaction	A cardholder transaction for which the merchant imprints the credit card and submits a paper sales draft to the acquirer for collection. The paper draft is sent to the processing center where it is processed and transferred to magnetic tape for transmission through interchange.
Pay-Ahead Programs	Programs which allow cardholders to skip a payment or payments based on the excess of the remitted payment in one month being applied to one or more future months. They are also known as pre-payment programs.
Payment Hierarchy	The order in which the cardholder's payment will be applied to fees, purchases, and other charges.
Payment Holiday Programs	Programs which enable cardholders to defer their minimum monthly payments. These programs are normally used during high purchasing periods such as holidays or peak vacation periods and are also known as skip payment programs.
Penalty Pricing	Pricing that is higher than a card's standard rate and that goes into effect as a result of adverse activity, such as for late payment or for otherwise not abiding by the cardholder agreement.
Podcasts	Sound-bites that are downloadable from a website and that can be played on an iPod.
Point-of-Sale Transactions	Face-to-face transactions in which the cardholder uses the physical card at a merchant's physical place of business.
Pre-Payment Programs	Programs which allow cardholders to skip a payment or payments based on the excess of the remitted payment in one month being applied to one or more future months. They are also known as pay-ahead programs.
Processing	Generally refers to activities that do not involve customer contact or risk management. For example, transaction authorization and cardholder billing are considered part of processing. Activities that generally involve customer contact and risk management (such as customer service and credit review) are considered servicing, not processing. Processing is commonly labeled as front-end processing and back-end processing. Transaction authorization and routing transactions from the point-of-sale to the network are examples of front-end processing while handling the information and payment flows needed to convert the electronic transaction record into cash for the merchant are examples of back-end processing.
Promises Kept	The amount of payments made by cardholders as compared to the amount of payments promised by those cardholders. This could also be measured by number of payments made compared to number of payments promised.

Promises to Pay	The amount of payments that cardholders promise to pay as a result of the bank's collection activities. This can also be measured as a count (compared to a dollar volume).
Promotional Rate	A short-term, temporary interest rate. It is also known as an introductory rate or teaser rate.
Purification	The practice of reversing uncollectible accrued fees and finance charges against earnings rather than accounting for them as charge-offs against the ALLL. Purification results in lower charge-off ratios when the accrued and unpaid fees and finance charges are included in the outstanding principal balance (denominator) yet the charged-off uncollectible accrued fees and finance charges are not included in the charge-off number (numerator).
Qualified Special Purpose Entity (QSPE)	In a two-step securitization structure, the QSPE is the entity that issues the certificates (the second step). QSPEs are designed to operate with limited decision-making authority. Whether or not the securitization vehicle is a QSPE is very important for determining whether or not the assets and liabilities of the QSPE should be consolidated. The goal is to avoid consolidation. In accordance with FAS 140, there are three qualifying conditions: i) legal isolation, ii) the ability of the transferee to pledge or exchange the transferred assets, and iii) surrender effective control.
Re-aging	Returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that are contractually due. Certain requirements must be met to be able to re-age an account, as discussed in the Portfolio Management chapter.
Recourse	Recourse arises from an arrangement in which a bank retains, in form or in substance, the credit risk in connection with an asset sale in accordance with GAAP, if the credit risk exceeds a pro-rata share of the banks claim on the assets. Examples of recourse include off-balance sheet contractual agreement to repurchase assets, spread accounts, cash collateral accounts, retained subordinated certificates, and retained subordinated IO strips.
Recoveries	Monies collected on an account after it has been charged-off. Recovery usually results from action taken by the collection department and may include legal action or agency referrals.
Refreshed Credit Scores	Credit scores that have been updated (after origination) to reflect changes in the consumer's profile that may have occurred since the original credit score was recorded.
Reissue	The process of preparing and distributing new credit cards to cardholders whose cards have expired or will soon expire (if the bank has determined that it will renew the relationship). It also encompasses supplying replacement cards to cardholders for lost or stolen cards.

Reject Inferencing	Specific inferences made by management about rejected applicants in order to determine if the applicants would have been a good or bad credit risk.
Residual Interests	Residual interest refers to any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with GAAP) of financial assets, whether through a securitization or otherwise, and that exposes a bank to any credit risk directly or indirectly associated with the transferred asset that exceeds a pro-rata share of that bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests do not include interests purchased from a third-party, except for credit-enhancing IO strips.
Retrieval Requests	Requests for a copy of the original sales draft from the merchant. Issuers request a copy of the sales draft to verify features of the transactions such as a signature, no imprint, cardholder inquiry, or fraud analysis. Retrieval requests usually precede a charge-back. Failure by a merchant to follow through with the retrieval request may, in and of itself, result in a charge-back. Retrieval requests are also known as inquiries.
Revolvers	Cardholders who roll over part of the outstanding balance to the next month instead of paying the balance in full.
Risk-Based Pricing	The practice of charging different rates on the same type of loan to different consumers, depending on each consumer's credit score and other factors which are believed to influence the likelihood of repayment. In risk-based pricing, consumers who are more likely to default are priced higher (with the intention that they would then be helping to pay for costs they cause the company), while consumers who have better repayment records get lower interest rates because they are not anticipated to create as many costs to defray.
Roll-Rate	The percentage of balances or accounts (units) that move from one delinquency stage to the next delinquency stage. They measure the rate that accounts (units) or balances move (roll) to the next level of delinquency and are used in migration analysis.
Scoring	The assignment of points to specific items of information to predict an outcome. The information is normally drawn from the application, internal performance, or a credit report. Scoring usually involves statistical modeling and is intended to help creditors accurately establish business and financial objectives and control levels of risk.
Securitizing	The process of packaging a good or product, such as credit card receivables, and transforming it into securities.
Segmentation	The process of parceling or stratifying the portfolio into various homogenous groups for closer analysis.
Settlement	As the card sales transaction value moves from merchant to acquiring bank to issuer, each party buys and sells the sales ticket. Settlement is what occurs when the acquiring bank and the issuer exchange funds during that process. On more technical terms, it is the final, irrevocable transfer of funds between parties in a payment system. (This should not

be confused with the term settlement as used to refer to a debt forgiveness situation.)

Skip Payment Programs	Programs which enable cardholders to defer their minimum monthly payments. Normally these programs are instituted by management during high purchasing periods such as holidays or peak vacation periods. They are also known as payment holiday programs.
Split Sales Drafts	The process by which a merchant uses two or more sales drafts for a single transaction to avoid authorization limits. This differs from split tender sales which involve two or more forms of payment (for example, cash and credit card).
Spread Accounts	In a securitization, the governing documents may require that if specific performance indicators fall below certain thresholds, any excess spread will be "trapped" into an account (the spread account) for the benefit of the certificate holders as a form of credit enhancements against future credit losses. The performance indicators are usually based on the performance of the underlying receivables, rating agencies' actions, or excess spread falling below a specified threshold.
Subprime	Exhibiting characteristics that indicate a significantly higher risk of default than traditional bank lending customers. Risk of default may be measured by traditional credit risk measures (credit history, debt to income levels, and so forth) or by alternative measures such as credit score.
Teaser Rate	An initial offering of an interest rate lower than the normal stated rate charged to a cardholder. The issuer's strategy is to attract an interest-sensitive borrower and run up the borrower's balance quickly by offering easy transfer of existing credit card balance from other institutions. A teaser rate is also known as an introductory rate or promotional rate.
Total Assets Under Management	The total of on-balance-sheet assets plus securitized assets. This term is synonymous with managed assets.
Unexpected Losses	The potential for actual loss to exceed the expected loss and is a measure of the uncertainty inherent in the loss estimate. It is this possibility for unexpected losses to occur that necessitates the holding of capital protection.
Universal Default	When a lender changes the terms of a loan from the original terms to the default terms when it is informed that its borrower has defaulted with another lender.
Usury	Interest charged in excess of the legal rate established by state law.
Utilization	The portion of the credit limit that is being used. For example, if a card has a credit limit of $1,000 and its balance is $300, utilization is 30 percent.

Valuation Allowance — In general, an account established against a specific asset category or to recognize a specific liability, with the intent of absorbing some element of estimated loss. Such allowances are created by charges to expense in the Report of Income, and those established against asset accounts are netted from the accounts to which they related for presentation in the Report of Condition.

Vintage — The date (time period) a cardholder's account originated.

Warehouse Facility — The borrowing of funds by a retail lender on a short-term, revolving basis using the loans as collateral. This form of interim financing is used to raise funds to make the loans and carry the loans until they are securitized (packaged and sold out of the warehouse to the investor). Proceeds from the sale are then used to reduce the warehouse loan.

APPENDIX A

CREDIT CARD PRE-EXAMINATION REQUEST LIST

The request list housed in this appendix is meant to augment the typical examination request list that is sent to the bank (that covers traditional examination review areas such as liquidity, rate sensitivity, capital, budgets, strategic plans, and so forth). This credit card pre-examination request list is for example purposes only. It contains numerous suggested request items, many of which may not be applicable to or necessary to obtain for the specific bank under review. As an example, it contains sections for issuing Rent-a-BINs, merchant programs, and securitizations, which not all banks will have. Examiners should customize the request list for the bank being examined. The example list, which not a required format, can be scaled down, added to, reworded, and so forth. The italicized information within parentheses needs to be input based on the applicable situation (examination date, asset review date, and so forth). It may also be helpful to identify specific reports by name if the examiner preparing the request list is familiar with reports normally prepared by the bank. Management should already be reviewing information similar to many of the requested items and, as such, can be encouraged to submit reports that it uses on a regular basis when such reports are similar to requested items. That can, in turn, not only limit the amount of time management must spend on compiling reports for the examination but will also allow the examiner to get a better feel for the quality of management reports normally used by management. That is not to say that customized reports won't be necessary during the examination, but, rather, that examiners should normally work with management's standard reporting to the extent possible.

Information gathered during the examination is not limited to that identified on the pre-examination request list. Rather, numerous reports and other items of interest are requested during the examination, often to either support, expand upon, or delineate information already provided or to gather information on other areas of potential concern that may have only recently come to the examiner's attention.

CREDIT CARD PRE-EXAMINATION REQUEST LIST

Whenever possible, please provide credit card portfolio data in a format that distinguishes between bank-owned, securitized, and managed portfolios (if applicable) and/or along any other key segmentation lines used by management. For requests regarding statistical information for the credit card portfolios, we ask that management provide the data in (*hard copy (not originals), secure electronic, or both*) format. For reports, identification of the report's preparer would also be helpful, in the event there are questions regarding data sources, calculations used, and so forth. The requested information should be provided as of (*date*) unless otherwise indicated and should be delivered to the (*city, state*) field office by (*date*). If you have any questions regarding any of the requested items, please contact Examiner-in-Charge (EIC) (*name*) at (*phone number*) as soon as possible.

SECTION A - MANAGEMENT

1. The bank's most recent organizational charts for credit card operations, including each major functional area, and a brief description of principal positions.

    a. Resumes for those individuals new to principal positions since the prior FDIC examination.

2. List of committees that supervise credit card operations, including identification of the schedule and frequency of meetings. Also include committee fee structures, if applicable.

    a. Minutes from applicable committee meetings since (*date*).

3. Credit card policies/procedures covering, but not necessarily limited to, the following, if changed since the prior FDIC examination:

    a. Re-aging.
    b. Workout programs.
    c. CCCS accounts/programs.
    d. Charge-offs.
    e. Over-limits.
    f. Settlement programs (a.k.a. debt forgiveness programs).
    g. Bankruptcy.
    h. Fraud.
    i. Allowance for Loan Losses (ALLL) and other allowances.
    j. Credit line assignment strategies (initial line assignments as well as credit line increases and decreases).
    k. Re-issue/renewal practices.
    l. Account closures/suspensions.
    m. Account activation.
    n. Marketing.
    o. Underwriting.
    p. Rent-a-BIN (a.k.a. BIN-sharing).
    q. Any other material credit card operations.

4. The most recent management monitoring and exception reports used by the Board, senior management, or committees to monitor credit card marketing, underwriting, collections, operations, etc.

5. List of vendors used, including a description of services rendered. This list should include arrangements with all affiliates and related organizations. Also provide the following:

    a. Written contracts or agreements governing significant relationships and operations as well as relationships and operations with affiliates and related organizations.
    b. The most recent audits of those entities (significant relationships, affiliated, or related organizations).

6. For affiliates and related organizations playing a part in the credit card operations:

    a. A summary of all payments paid to and received from each applicable affiliate or related organization from (*date*) to (*date*).
    b. A summary of any reimbursement paid to an applicable affiliate by the bank or by an affiliate to the bank for any expenditure from (*date*) to (*date*).
    c. Committee reviews and meeting minutes regarding affiliated or related organizations for (*date*) to (*date*). Also provide any comparable transaction reviews completed for the affiliated arrangements during the same period.
    d. External or internal reviews of affiliate arrangements that were completed since the previous examination.
    e. Financial statements (balance sheets and income statements) as of (*date*) for the applicable affiliated and related organizations.
    f. A summary of any instances in which employees of the applicable affiliates, related organizations, or other third parties are providing services to the bank without compensation.
    g. A summary of any instances in which bank employees are providing services to an applicable affiliate, related organization, or other third party without compensation or reimbursement from the other party.

7. Visa/MasterCard agreements and correspondence from/to those entities from (*date*) to (*date*).

8. Agreements and correspondence with any other applicable networks or systems (Discover, American Express, and so forth) from (*date*) to (*date*).

9. If not detailed in the correspondence provided pursuant to items A7 and A8, a description of any restrictions set forth by the networks since the prior examination, any collateral/pledging requirements placed on the bank since the last examination, or any other financial obligations (fines, penalties, and so forth) placed on the bank by the networks.

10. List of the bank's BINs (Bank Identification Numbers or other similar numbers from other networks), including what each is used for (acquiring, issuing, etc.), whether each is rented out to another entity (known as a BIN-sharing or Rent-a-BIN arrangement), and which entity that is.

11. Balance sheet and income statement for the credit card department (*timeframe (for example, the most recent five quarters*).

12. Chart of accounts, including descriptions thereof, used for credit card activities.

13. List of models used. Include:

    a. Identification of whether each model was developed internally or was purchased from a vendor (and if so, which vendor).
    b. Description of each model's use (and intended use, if different).
    c. Date of each model's most recent calibration.

   d. Date of each model's most recent validation.
   e. Description of any models in development (either internally or externally).

14. If not provided for in other requests within this document, provide management's analyses and actions to ensure compliance with the January 8, 2003 Interagency Account Management and Loss Allowance Guidance for Credit Card Lending. Also include the most recent internal audit reviews thereof.

15. A summary of accounting practices used. For example, FAS 91 procedures, including identification of the specific fees and expenses that are deferred and timeframes for deferment, FAS 140 procedures, etc. Also include applicable accountant's opinions.

SECTION B - MARKETING

1. Marketing strategy documents.

2. A description of marketing tests completed since (*date*).

3. Chronological order/summary of marketing/acquisition activities and associated statistics since (*date*). Please make marketing materials (mailed offers, take-one applications, and so forth) available on-site.

4. Customer response rates and underwriting approval rates segmented by vintage and marketing channel. Please provide monthly supporting data from (*date*) to (*date*).

5. List of anticipated new products or solicitations planned for the upcoming (*number*) months.

6. Matrix of all possible combinations of pricing terms for all credit card products.

7. If not included in the pricing information in item B6, please provide information (fee amounts and assessment practices) for all punitive fees (late fees, over-limit fees, and so forth).

8. A copy of a current cardholder agreement for each product offered.

9. A summary of significant changes to cardholder agreements since (*date*). For example, changes in minimum payments, fees, and so forth.

10. Contracts for significant or new (since the prior FDIC examination) affinity programs, private label programs, or other partnerships. Also provide brief summaries regarding these programs, including rebate reserve policies, methodologies, and most recent analyses.

11. Details regarding significant or new rebate/points/gift coupons/discounts/rewards programs, and management reports regarding these programs.

12. Applicant data used prior to application.

13. Vintage delinquency and charge-off performance by product and distribution channel (# and $) (current, 1-29, 30-59, charge-off, and so forth).

14. Information regarding Internet or on-line banking programs, including the costs to administer these programs. If accounts are being booked via these marketing channels, provide data regarding the monthly volumes of accounts (# and $) and the performance of these accounts.

SECTION C - UNDERWRITING

1. A summary of the bank's underwriting policies and practices, including a summary of any significant changes that have occurred since (*date (usually the previous examination*)).

2. Documentation for each scorecard used, including (but not limited to) identification of its age, vendor, and use. Please include:

    a. Odds Tables.
    b. Override Reports.
    c. Summary reports detailing accounts segregated by current score ranges as of (*date*). Provide application score reports if periodically updated. Also provide portfolio distribution by other scoring systems used by management (for example, behavior scores).

3. Validations of scoring models, including supporting documentation thereof.

4. Documentation describing frequency and procedures for validating scoring systems (that is, validation policies).

5. Documentation detailing the most recent calibrations of significant scoring systems.

6. Report showing credit limits granted on each portfolio segment. Include maximum, minimum, and average.

7. For pre-approved solicitations, criteria used to generate solicitation lists. Include procedures for eliminating prospects from lists and any post-screening activities.

8. FICO score distribution at origination by portfolio segment.

SECTION D - RISK MANAGEMENT

1. Key reports produced and monitored by risk management on a regular basis. Please provide the most recent reports (through (*date*)) and include any commentary provided by the risk management department regarding the department's analysis of these reports.

2. The most recent (through (*date*)) system reports utilized by management to monitor portfolio performance, if not already provided. Identify the individuals or groups that use the reports.

3. If not already provided, month-end system reports as of (*date*) and (*date*) that, at a minimum, include month-end receivable balances, month-end delinquencies, and monthly principal and interest losses. Also include reconciliations of these system reports to the general ledger for (*date*) and (*date*) and include any reports management uses to reconcile the system reports to the Call Report.

4. If not already provided, a refreshed distribution of FICO scores as of (*date*) for each portfolio segment. Please provide the distribution of credit bureau scores in (*number*) point increments. Also, breakout no-score accounts.

5. If not already provided, roll-rate analysis (or other migration analysis) for the past 13 months through (*date*). If available, please provide the information by $ and #.

6. If not already provided, monthly amounts of interest and fee losses for the past 13 months through (*date*) and provide the ratio of monthly interest and fee losses in relation to total charge-offs for each month.

7. If applicable, a description of when interest and various fees stop accruing during the delinquency cycles.

8. Monthly recoveries for past 13 months through (*date*).

9. Monthly bankruptcies for past 13 months through (*date*).

10. Monthly fraud reports/losses for past 13 months through (*date*).

11. Monthly volumes of losses (# and $) due to first payment defaults (accounts in which cardholders never made a payment) for the past 13 months through (*date*). Please separate into “no-use, no-pay” and “use, no pay,” if applicable.

12. A copy of the Allowance for Loan and Lease Losses (ALLL) analysis that is routinely provided to the board of directors. In addition, provide a copy of the ALLL calculation and assumptions for (*dates*). Include a summary of how interest and fee losses are provided for in the ALLL, or in a separate allowance, and supporting calculations and assumptions. If interest and fee losses are reversed or purified against the income statement, provide the General Ledger accounts utilized.

13. A summary of any changes to the ALLL methodology since the previous examination and the corresponding impact on the ALLL balance from those changes.

14. A summary of how credit risk relating to hardship accounts, re-aged accounts, and over-limit accounts are accounted for within the allowance methodologies (if not included in the provided policies).

15. A summary of the 12-month allowance look-back analysis and a reconciliation and explanation of variances between actual and projected losses (that is, the reconciliation between actual losses and projected losses) for (*financial statement date*).

16. A listing of charged-off receivables that have been re-booked, including details as to when and why the receivables were placed back on the books.

17. A summary of any instances in which a cardholder can make a payment less than the minimum due and still remain current (or not roll further delinquent) (if not included in the provided policies).

18. Management’s internal capital adequacy assessment for (*date*). The capital assessment should address the guidelines provided within the Interagency Guidance on Subprime Lending and the Interagency Expanded Guidance for Evaluating Subprime Lending Programs, if applicable. Also provide documentation regarding the method used to complete the capital assessment.

19. The bank’s (*date (or most recent)*) subprime analysis including any supporting documentation.

20. Profitability reports assessing the performance of the loan portfolio and its segments.

21. Monthly reporting of new accounts in each program/segment for (*date*) through (*date*).

22. The monthly number and dollar volume of credit line increases for (*date*) through (*date*).

23. A summary/matrix of criteria used in assessing credit line increase eligibility, size of line increases granted, and frequency accounts are eligible for a line increase (if not included in the provided policies).

24. Reports/analyses used to monitor the performance of accounts that have been granted credit line increases.

25. Reports for (*date*) through (*date*) used to monitor the portfolio of over-limits. The information should identify, but is not limited to, count and dollar volume of accounts over-limit, tracking by percentages or utilization bands, performance of over-limit accounts (period of time over-limit, delinquency status, and so forth).

26. A narrative description of the behavior scoring system or other similar programs/systems that are used to identify credit card loans with higher risk. Please indicate how each system is used, including functions such as account approval, credit line management, collections, etc. Provide summary reports showing the results of the analyses for (*date*) through (*date*).

27. Delinquency reports by credit score and/or behavior score.

28. Monthly attrition rates for each program/segment for (*date*) through (*date*) and other attrition reports utilized by management. Please provide a narrative summary of retention strategies used by the bank (if not already included in the policies provided).

29. The following credit card information on a monthly basis for (*date*) to (*date*):

    a. Count and dollar volume of outstanding active or open card accounts.
    b. Outstanding receivables.
    c. Delinquency amount for each bucket. Please provide by channel, portfolio (managed, trust, and bank-owned), segment, etc.
    d. Roll rate analysis or other migration analysis used. If available, please provide the information by number of accounts and by dollar volume.
    e. Gross charge-offs broken down by category. For example, fraud, first payment default, bankruptcy, death, settlement, and delinquency.
    f. Principal losses.
    g. Interest and fee losses.
    h. Principal recoveries.
    i. Fee and finance charge recoveries.

30. A breakout of portfolio segments by months-on-books as of (*date*).

31. For accounts on-book as of (*date*), a breakout of FICO scores at origination.

32. Reports used to monitor performance of cardholders with multiple accounts.

SECTION E - ACCOUNT MANAGEMENT

1. Criteria for establishing initial credit limits, renewals, payment deferral programs, and pre-payment programs, if not detailed in other credit card policies already provided.

2. Customer service reports. For example, those showing frequency of contact and percent of calls being handled by voice response units.

3. A summary of the payment processing function, including a flow chart if available.

4. Summary information regarding the count and dollar volume of cardholder payments received monthly from (*date*) through (*date*).

5. A summary of the daily settlement process, including a flow chart if available.

6. Within the summaries and flow charts for request #3 and request #5, include the names and account numbers of general ledger accounts used.

7. Summaries of procedures/processes for suspense items and for rejected items.

8. For accounts that were over-limit in (*month*), provide an aging of the number of consecutive months the accounts have remained over-limit (if not already provided).

9. Credit card payment application hierarchies.

10. A summary of authorization strategies.

11. A summary of the charge-off policies and procedures for delinquent, bankrupt, deceased, and settlement accounts (if not already included in the provided policies).

12. A description of processes used to ensure the timely resolution of settlement (a.k.a. debt forgiveness) accounts.

13. A summary of bank policies and procedures regarding loan loss recoveries in excess of principal losses recorded to the ALLL. Please provide an example of how these amounts are recorded and the dollar amount for the last 12 months.

14. Management's most recent negative amortization analysis. Also include a description of any changes made to the minimum payment structure(s) since the prior examination.

SECTION F - COLLECTIONS

1. If not provided in the policies requested in other sections of this document, please provide collection policies and procedures/strategies by product and distribution channel including:

    a. Disputes.
    b. Penetration rates.
    c. Litigation.
    d. Notice of default.
    e. Account suspensions, closures.
    f. Discount programs, seasonal programs, promotional programs, gift programs, special awards, or prize programs (customers or employees), etc.
    g. Outsourced accounts.
    h. Sold accounts/receivables – pre/post charge-off.
    i. Fee waiver, concession, or reversal practices.

2. Key management reports used by the collections department to monitor the effectiveness of collection efforts.

3. A description of how accounts are assigned to collectors. Also provide management's analysis of collections staffing requirements/needs.

4. If third-party collectors are used (pre- or post-charge off), performance metrics used to monitor performance of those collectors.

5. Data on closed accounts (voluntary/involuntary).

6. Monthly delinquency and charge-off reports for each internal and external loan workout program (including CCCS) from (*date*) through (*date*).

7. A summary report of re-aged accounts that includes the monthly volumes (count and dollar volume) of accounts re-aged from (*date*) through (*date*).

8. A summary of workout programs that includes the monthly volumes (count and dollar volume) of accounts in such programs from (*date*) through (*date*).

9. The most recent management reports used to monitor the performance of re-aged accounts, workout accounts, and similar accounts. These reports should address, at a minimum, the monitoring requirements set forth within the Interagency Uniform Retail Credit Classification and Account Management Policy and the Interagency Account Management and Loss Allowance Guidance for Credit Card Lending.

10. Settlement (a.k.a. debt forgiveness) guidelines and/or matrices for in-house collectors and managers. Please provide the same for accounts that have been referred to collection agencies, third-party collectors, or attorneys. Also, provide a summary of management's loss recognition practices for settlement accounts.

11. Management reports regarding monthly fee waiver/credit volumes for (*date*) through (*date*).

12. Policies and procedures for pay-ahead, skip payment, and similar programs. Please include the current system settings for those programs as well as a summary of system setting changes for those programs since the previous examination.

13. Information regarding credit card receivable sales to third parties, including affiliates, (pre- or post-charge off).

14. A summary of any significant changes in collections strategies/procedures since the previous (*FDIC, state*) examination.

SECTION G - PORTFOLIO ACQUISITIONS

If one or more portfolios have been purchased since the prior (*FDIC, state*) examination, please provide the following items:

1. Details regarding the number of accounts and dollar volume of receivables, as well as, performance information on the acquired receivables.

2. A description of procedures used to perform due diligence on the portfolio acquisitions.

3. A copy of the bank's original acquisition model detailing purchased credit card relationships (PCCRs).

4. A copy of the most recent quarterly fair market value model for PCCRs.

5. A copy of the documentation detailing amounts of capitalized ALLLs related to PCCRs.

6. Summary of accounting used to book the acquisition.

SECTION H – SECURITIZATIONS

1. A copy of the strategic or business plans for credit card securitization activities.

2. A copy of the primary and contingency liquidity funding plans as they relate to credit card securitization activities.

3. A copy of all written policies and procedures on credit card securitization.

4. A listing and account description of all general ledger accounts associated with the securitization function and corresponding Call Report line items.

5. A copy of the last 12 months of performance reports provided to the trustee (i.e. monthly determination date statements/monthly servicer's certificate statements) for each outstanding securitization facility.

6. A copy of the current organizational chart of the credit card securitization unit, including telephone numbers for each individual.

7. A list and meeting schedule for all board and/or senior management committees that oversee credit card securitization activities. For meetings since the previous FDIC examination, please make meeting minutes and attachments provided to committee members available on-site.

8. Access to the prospectus or series supplement, pooling and servicing agreement, and all other documents for each outstanding securitization transaction. This should include all legal and accounting written opinions received in connection with the transactions.

9. Information detailing the potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized credit card receivables.

10. Documentation concerning the most recent residual valuation model validation.

11. Residual valuation model input and output that supports the values reported in the (*date*) Call Report and the initial value estimate.

12. Supporting documentation for the assumptions used to value the retained interests (discount rate, gross cash yields, default rate, loss severity rate, payment rate, etc.).

13. Management's analysis for any subordinated tranches or classes retained by the bank or its consolidated subsidiaries.

14. Management reports that are used to monitor non-securitized and securitized loan performance (e.g. stratified by credit score, behavior score, and so forth) for the (*date*) Call Report, if not already provided for elsewhere in this request list.

15. Original and refreshed credit score distribution for securitized and non-securitized assets, if not already provided.

16. Securitization summaries, including a description or flow chart of the cash flow priorities (waterfall) for each outstanding transaction.

17. Performance reports by portfolio and specific product type. Performance factors include, but are not limited to, gross cash yield, charge-off rate, delinquency rate, payment rate, and excess spread amount. Please include reports for securitized and non-securitized loans, if not already provided.

18. Vintage analysis for each pool securitized using monthly data.

19. Most recent static pool cash collection analysis.

20. Sensitivity analysis for all major assumptions used in the interest-only (IO) strip valuation model.

21. Statement of covenant compliance for all relevant deal triggers.

22. Securitized loans that have been re-aged, modified, or restructured, if not already provided.

23. A list of any action to support the trust, or improve the overall trust performance, beyond the contractual obligations of the issuing bank. Examples of this include, but are not limited to, repurchasing loans from the master trust at above-market price or selling loans to the master trust at a discount.

24. A list of any assets repurchased/removed from the master trust.

25. A description of any agreement subsequent to the original securitization documents amending the terms or structure of the outstanding series.

26. A description of how the IO strip, servicing asset/liability, and other credit-enhancing assets are reported in the Call Report. Please provide access to supporting workpapers on-site.

27. A schedule supporting the leverage and risk-based capital calculations for credit card securitization activity.

28. A copy of the general ledger entries made upon the closing of each securitization issuance (i.e., removing transferred assets from the books and recording retained interests) in accordance with FAS 140.

29. The most recently completed impairment analysis and initial valuation calculation for excess servicing (IO strip securities/residuals). Please clearly identify how current and future monthly cash flows from securitizations support current asset carrying values.

30. Access to the actual valuation model (on-site).

31. The most recently completed impairment analysis and initial valuation calculation for servicing assets. Explain the procedures and methods used.

32. All general ledger entries illustrating the entries made upon subsequent sales of assets to the master trust that resulted in the recognition of a gain or loss.

33. The most recent internal and external audit reports (including any SAS 70 reports or agreed upon procedure engagements) addressing credit card securitization and management's response to identified deficiencies. In addition, please provide access to external audit work papers, engagement letters, and all written correspondence with auditors.

34. A description of the current processes, time frames, and procedures for timely loss recognition and nonaccrual treatment for defaulted loans, if not already provided.

35. A description of the terms and conditions for re-aging, extension, modification, and loss mitigation activities, if not already provided.

36. If the bank is also the servicer, a copy of the most recently prepared management report for servicing which outlines operational results. Please include, at a minimum, securitized and non-securitized asset vintage level delinquency rates, roll rates, loss severity factors, and cumulative loss information, if not already provided.

37. A list of servicing fees received and evidence (internally or externally completed) that the fee represents adequate compensation pursuant to FAS 140.

38. Identify and explain any recourse provisions in servicing contracts.

39. A listing of all servicer advances on a per transaction basis and whether or not such advances have credit-enhancing features.

40. On-site access to the correspondence file(s) showing requests from, and responses to, rating agencies, investors, etc.

41. All investor, rating agency, or other third-party audits of servicing activities and insurance wrap companies.

42. All policies that describe permissible hedging activities and instruments.

43. A list of all instruments used for hedging purposes including the amount, origination, expiration, terms, and counterparty information.

44. Documentation required in accordance with FAS 133 maintained by the bank to ascertain and monitor hedge effectiveness.

SECTION I - MERCHANT PROGRAMS

1. New merchant report or management summaries for the previous three months.

2. Credit risk management reports for merchant accounts.

3. Top (*number*) merchants by volume.

4. Merchant concentration reports by code and by state or geographic area.

5. Brief explanation of sales/account acquisition channels.

6. A listing of all insider-related merchant customers.

7. Merchant agreements for significant and new relationships.

8. List of all merchant reserves.

9. Profitability report for the merchant department for the most recent year-end as well as year-to-date.

10. Fee schedule.

11. Profitability reports by sales segment.

12. Example of a merchant profitability analysis, if available.

13. Report detailing total number of merchants, annual volume of sales, and number of transactions.

14. Listing of unprofitable merchant accounts.

15. Attrition report for the past year.

16. Brief summary of agent bank programs offered.

17. Name and address of agent banks, and respective merchant volumes per agent bank.

18. Agent bank agreements for significant and new relationships.

19. List of third-parties used including name, address, and description of service rendered (if not already provided for elsewhere in this request list).

20. Most recent bank audit report of Independent Sales Organization (ISO) / Member Service Provider (MSP) activity and ISO/MSP response.

21. Summary of which ISO/MSPs have access to the acquirer's data processing system and the extent of the access (e.g. set up, charge-backs, or maintenance).

22. List of all ISO reserves.

23. A flow chart and brief explanation of the settlement process that illustrates the parties involved and the timing of settlement (if not already provided).

24. Management summary of underwriting exceptions/overrides.

25. Daily fraud monitoring reports.

26. Charge-back aging report, charge-back ratios and trend analysis.

27. Fraud loss history.

28. Credit loss history.

29. Most recent internal/external audit reports and management's responses thereto.

30. Information on merchant portfolio acquisitions (date acquired, who acquired from, summary of portfolio acquired, etc.).

31. Due diligence processes used for portfolio acquisitions.

32. Management reports used to monitor and manage acquired portfolios.

33. Please make the following available on-site:

    a. Merchant processing policy and procedure manuals.
    b. Committee minutes for merchant-related activities.
    c. Recent reports issued by the Associations.
    d. Merchant files.
    e. Inventory logs for credit card equipment maintained for resale or lease to merchants.
    f. Agent bank files.
    g. Third-party credit files including current financial statements of ISOs/MSPs.
    h. Third-party written contracts and agreements, including, but not limited to, contracts between ISOs/MSPs and the bank's data processor (if the bank does not have it own in-house operation).
    i. All Association/network correspondence, including, but not limited to, quarterly processing statements, pledge agreements, fraud monitoring reports, and charge-back monitoring reports.
    j. Contingency plans for third-party organizations, and management's review of the plans.
    k. Audit workpapers.

SECTION J – CREDIT CARD ISSUING RENT-A-BINS

1. Rent-a-BIN policies.

2. On-site access to committee minutes regarding Rent-a-BINs.

3. Current organizational chart for Rent-a-BIN activities, including a phone number for each individual.

4. For each Rent-a-BIN program, a list of the parties involved (receivables holder, servicer, processor, and so forth), including company name, address, primary contact and phone number, and principals, and a description of the product(s) offered.

5. A list of terminated or discontinued Rent-a-BIN arrangements, including a description of the arrangement and the reason terminated or discontinued.

6. A list of prospective Rent-a-BIN programs that management is considering (include name and address of prospective partner as well as a description of the product that may be offered).

7. On-site access to marketing materials for all Rent-a-BIN programs.

8. For arrangements new since the last FDIC examination, a summary of due diligence processes used.

9. BIN rental agreements and any associated receivable purchase/sale agreements for significant Rent-a-BIN programs as well as for Rent-a-BIN programs new since the prior FDIC examination.

10. A summary of any significant changes to any other existing Rent-a-BIN contracts (those not provided in item J5). Examples would include changes in pricing terms, reserves or collateral requirements/calculations, and so forth.

11. Summary of practices that are used to oversee the card portfolios subject to Rent-a-BIN arrangements and that are used for program oversight (monitoring of the partner's performance and financial condition and so forth).

12. Summary data for each Rent-a-BIN program (count and dollar volume of card accounts, open-to-buy amount, delinquency volumes and ratios, charge-off volumes and ratios, re-age volumes, and so forth).

13. Additional card portfolio information for new or significant Rent-a-BIN programs and that is regularly reviewed by management to monitor such programs (examples would include reports that go to the board of directors and significant reports that are monitored by the individual(s) responsible for program oversight).

14. The calculations for settlement reserves (for example, deposits held at the bank or at a third party) for each significant or new relationship as of (*date (usually Call Report date or Asset Review date)*).

15. Data on recent settlement and cardholder purchase/cash advance volumes (for example, daily volumes, averages, trends, and so forth).

16. Documentation that is reviewed by management to confirm whether or not the contracted party is in compliance with contract terms, covenants, and parameters.

17. Documentation of compliance with applicable regulatory guidance, including the January 8, 2003 Account Management and Loan Loss Allowance Guidance for Credit Card Lending.

18. Audits of Rent-a-BIN arrangements and management's responses thereto.

19. A summary of litigation regarding the Rent-a-BIN program, including any card accounts issued thereunder, if not already provided.

20. Profitability reports for overall Rent-a-BIN operations as well as for each significant or new Rent-a-BIN arrangement, if available.

21. The bank's contingency plans for its Rent-a-BIN programs as well as a summary of procedures used to review applicable third-parties' contingency plans for the programs.

22. Summary of instances in which settlement reserve deposits, collateral, or other similar protection devices have been tapped.

Account Query and Sampling Request
(Bank)
(Date) Safety and Soundness Examination

Please provide data queries for the following types of accounts and provide data in electronic format by (*date*). You are encouraged to send the electronic information via FDIC Connect. The queries will be used for account sampling during the examination. In some instances, review of consecutive months of information may be necessary; therefore, we request read-only on-line access, including print capabilities, for the examination. Please contact the EIC by (*date*) to discuss the particulars of on-line access, or, if on-line access cannot be granted, to make other arrangements.

If possible, please retain these data queries in case we determine that further queries on this information are necessary. When possible, please provide the following information/data fields with each query: account number; month and year the account was booked/origination date; credit limit; current balance; interest rate; credit score; behavior or other internal scores; delinquency history; date of last re-age; and date of last payment. Also provide a list and descriptions of all transaction codes, internal and external status codes, reason codes, PCF parameters, and so forth that would assist us in reviewing the account information.

1. Identify all accounts that were both past due as of (*date*) and current as of (*date*).

2. Identify all accounts that were ever $\geq$ 180 contractual days delinquent since (*date*) and have not been charged-off to date.

3. Accounts with an NSF payment in (*month*).

4. Accounts that had any type of credit, other than a cardholder payment, applied to them in (*month*).

5. Accounts that were re-aged in (*month*).

6. Accounts booked in (*month*).

7. Accounts placed in a workout program in (*month*). If the bank has more than one type of workout program, please provide separate queries for each program.

8. Accounts booked in (*month*) with credit scores and/or application scores below the bank's cutoff scores (i.e. low score overrides).

9. Accounts charged-off in (*month*) as first payment default accounts.

10. Accounts that were charged-off due to delinquency status in (*month*). Please indicate if this query includes first payment defaults that are reported in query 9.

11. Accounts with credit line increases in (*month*) and (*month*). Please include the account balance, delinquency status, credit line limit, and scores (if used to qualify for the line increases) prior to the credit line increase. Also provide the new credit limit as well as the date of most recent previous credit line increase.

12. For the months of (*months*), provide accounts with a minimum payment due of $0 but for which the account had a balance as of its cycle-end date. For the accounts in this query, please identify and provide in a separate file a summary report of accounts (count and dollar volume) that qualified for any pay ahead, skip payment, or similar feature.

13. Accounts charged-off in (*quarter or year*) and subsequently re-booked. Identify when and why the rebooking occurred.

14. Accounts that cycled in (*month*) where the balance (excluding new purchases and cash advances) increased in the past (*number*) consecutive cycles despite the cardholder making the contractual minimum payments due. For fees, use the assumption of all fees and finance charges included.

15. Accounts over-limit as of their (*month*) cycle that have been over-limit (*number*) consecutive months as of that cycle.

16. Accounts that entered a settlement agreement in (*month*).

17. Accounts with three or more consecutive insufficient funds payments since (*date*).

APPENDIX B

MERCHANT PROCESSING EXAMINATION TOOLS

Portfolio Profile Worksheet

	Prior Year-End	Current Year-to-Date
Sales Volume		
Number of Transactions		
Number of Merchants/Outlets		
Average Ticket Size		
Number and Dollar Reserves		
Major Third Parties and Services Provided		
Top Three Concentrations by Geographic Distribution		
Top Three Concentrations by Industry		
Top Three Concentrations by Volume		
Charge-back Percentage of Sales		
Charge-back Loss Volume		
Fraud Loss Volume		
Operational Loss Volume		
Niche Market		
Net Income/Contribution		
Percent Electronic vs. Paper		

The portfolio profile worksheet can be used to summarize the profile of merchant portfolio at each examination and track changes in the profile from one examination to the next.

Income and Expenses

(Sample Only)

VOLUMES (000's)	EXPENSES
Total Sales Volume	External Data Processing
Total Transactions	Internal Data Processing
Average Ticket	Research and Development
	Terminal expense/depreciation
INCOME	Personnel
Gross Merchant Discount	Telephone Expense
Interchange (-)	Occupancy Expense
Assessments (-)	Travel & Entertainment
Net Merchant Discount	Supplies
Interest Income	Professional Fees
Transaction Fees	Fraud and chargeback losses
Terminal Fees	Miscellaneous Expenses
Miscellaneous Fees	
Total Income	Total Direct Expenses
Total Income Per Transaction	Total Allocated Expenses
Return on Total Income	
Return on Total Expense	Total Expenses
Direct Expenses Per Transaction	Net Contribution Before Tax
Total Expenses Per Transaction (Unit Cost)	

This sample list of income and expenses associated with a merchant processing operation can be used in evaluating the bank's profit analysis of the merchant processing activity.

Merchant File Review Worksheet

Merchant Name				
Merchant Application				
- Signatures				
- Business Type				
- Description of Product and Services				
- Average Ticket Size				
- Volume Information				
- Social Sec. #/Tax ID				
- Trade and Bank References				
- Processor				
- Time in Business				
- Proper Approval				
Site Inspection				
- w/Photo				
- Inspected By				
Financial Information				
Credit Bureau Report				
Evidence of Previous Merchant Activity				
Check MATCH				
Purchase/Lease Equipment				
Discount Rate				
% Swiped Transactions				