

SCHWARTZ & BALLEN LLP

1990 M STREET, N.W. · SUITE 500

WASHINGTON, DC 20036-3465

(202) 776-0700

FACSIMILE
(202) 776-0720

schwartzandballen.com

MEMORANDUM

January 10, 2003

To Our Clients and Friends

Re: Banking Agencies' Guidance on Credit Card
Account Management and Loss Allowance Practices

The Federal Reserve, Federal Deposit Insurance Corporation, Comptroller of the Currency and Office of Thrift Supervision (the "Agencies"), acting under the auspices of the Federal Financial Institutions Examination Council, have issued guidance governing account management, risk management and loss allowance practices for credit card lending. The guidance outlines the Agencies' expectations for prudent practices in these areas.¹ The Agencies will require immediate corrective action when these practices are deemed inadequate or imprudent. The guidance applies to all insured banks and thrift institutions that offer credit card programs.

CREDIT LINE MANAGEMENT

When assigning credit lines or significantly increasing existing credit lines, the Agencies expect lenders to carefully consider the repayment capacity of borrowers. Institutions are expected to test, analyze and document line-assignment and line-increase criteria prior to implementation. Institutions should take into account and document decision factors such as repayment history, risk scores and behavior scores. Institutions that offer multiple cards are expected to have sufficient internal controls and management information systems to aggregate related exposures and analyze performance prior to offering additional credit lines.

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

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OVER-LIMIT PRACTICES

Over-limit practices are expected to be carefully managed and focus on reasonable control and timely repayment of amounts that exceed established credit limits. Over-limit authorization on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls.

MINIMUM PAYMENT AND NEGATIVE AMORTIZATION

The Agencies expect institutions to require minimum payments that will amortize the current balance over a reasonable period of time. The practices of prolonged “negative amortization”², inappropriate fees and other actions that inordinately compound or extend consumer debt and disguise portfolio performance and quality will be subject to examiner criticism.

WORKOUT AND FORBEARANCE PRACTICES

The Agencies are concerned with workout³ programs that have liberal repayment terms with extended amortizations, high charge-off rates, movement of accounts from one workout program to another, multiple re-agings and poor monitoring of program performance by management information systems. The Agencies expect the following:

- Workout programs should be designed to maximize principal reduction and generally to have debt repaid within 60 months. Institutions may need to reduce or eliminate interest rates and fees so that more of a borrower’s payment can be applied to principal reduction.
- Institutions should establish and maintain adequate loss allowances for credit card accounts subject to settlement arrangements. The amount of debt forgiven in a settlement arrangement should be classified as loss and charged off immediately.

² “Negative amortization” occurs when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and thus outstanding balances continue to build. As a result, the lender records uncollected income by capitalizing the unpaid finance charges and fees into the balance owed by the customer.

³ A workout is a former open-end credit card account upon which credit availability is closed, and the balance owed is placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization/liquidation of the balance over a defined payment period. Temporary hardship programs that help borrowers overcome temporary financial difficulties are not considered workout programs unless their duration, including renewals, exceed twelve months.

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INCOME RECOGNITION AND LOSS ALLOWANCE PRACTICES

To promote consistency in estimating incurred losses and loss allowances, the Agencies issued the following guidance:

- ***Accrued Interest and Fees*** – Institutions should evaluate the collectibility of accrued interest and fees on credit card accounts and employ methods, such as providing loss allowance for uncollectible fees and finance charges, to ensure that income is accurately measured. Institutions must account for the owned portion of accrued interest and fees, including related estimated losses, separately from the retained interest in accrued interest and fees from credit card receivables that have been securitized.
- ***Loan Loss Allowances*** – The loan loss allowance should be adequate to absorb probable and estimable credit losses. Institutions should ensure that their loan impairment analysis and loan loss allowance methodology, including the analysis of roll rates, consider the loss inherent in both delinquent and non-delinquent accounts.
- ***Allowances for Over-Limit Accounts*** – Institutions should ensure that their allowance methodology addresses the incremental losses that may be inherent in over-limit accounts.
- ***Allowances for Workout Programs*** – Accounts in workout programs should be segregated for performance measurement, impairment analysis and monitoring purposes. Adequate allowances (*i.e.*, estimated loss based on historical experience as adjusted for current conditions and trends) should be established and maintained for each workout program.
- ***Recovery Practices*** – Institutions must ensure that the total amount credited to the loan loss allowance as recovery on a loan is limited to the amount of the loan previously charged against the allowance. Any amounts collected in excess of this amount should be recognized as income.

The text of the guidance can be found at www.schwartzandballen.com/WhatsNew.htm.

If you have any questions concerning this guidance, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.