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Re: "Credit Card Lending - Account Management and Loss Allowance Guidance"

Dear Madame and Messrs:

On July 22, 2002, the four banking agencies[1] posted on the FFIEC web site a draft "Credit Card Lending – Account Management and Loss Allowance Guidance" ("Guidance") with a request that interested parties provide their comments electronically by August 9, 2002. The proposed Guidance appears to impact all commercial banks and savings associations that do credit card lending. The American Bankers Association ("ABA") brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership - which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks - makes ABA the largest banking trade association in the country. The ABA's Card Policy Council ("CPC") is an internal body composed of 15 of the largest credit card issuing banks as well as other credit card industry companies.

I. General Comments

First, the American Bankers Association and its Card Policy Council believe that the draft Guidance makes significant changes and additions to the Interagency Uniform

[1] The agencies are the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

Retail Credit Classification and Account Management Policy ("Policy"), published June 12, 2000, in the Federal Register.[2] Therefore, ABA and the CPC requested an extension of time to comment by letter dated July 31, 2002, and the agencies agreed to extend the comment period 45 days to September 23, 2002. ABA and the members of the CPC greatly appreciate the extension of time for comment.

Second, the ABA and the CPC believe that perhaps the most significant change in the Guidance is an overall shift in supervisory approach from one of portfolio review and management of the millions of consumer loans, including credit card accounts, to an increasing supervisory review of individual loans. Such a change requires significantly different management information systems (MIS) and operationalprocedures than are currently used by the industry, as is discussed in more detail in the specific comments, below. The agencies themselves know this, since in the adoption of the final Policy, the agencies stated: "Because a retail credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners."[3] If the agencies require such changes in MIS and operational procedures, then the industry will require an extensive implementation period. As the Guidance is written, it appears to require virtually immediate adoption of the changes made by the Guidance. Considerably more transition time will need to be provided in order for credit card lenders to implement the necessary changes to meet the requirements of the Guidance.

Third, the Guidance imposes new and specific limitations on credit card lending to "subprime" borrowers and on use and availability of workouts and settlements on all borrowers. These changes greatly limit the flexibility of lenders to work with borrowers experiencing temporary financial distress, in apparent contradiction to other initiatives of the agencies.[4] We believe that the agencies need to restore the flexibility of lenders to address the needs of borrowers experiencing temporary financial distress that the agencies have taken away with this Guidance.

Finally, ABA and the CPC are concerned about possible unintended consequences of the Guidance. We note that credit card lending has assumed an important role in the U. S. economy. Credit cards provide a valuable tool for effecting payments and accessing credit that has become a cornerstone of consumers' management of their finances. The ability to both address daily payment needs and deal with unforeseen, and often substantial, expenses is accommodated through a single vehicle that can be obtained from many competing providers on a wide variety of terms. Outstanding revolving credit loans exceed $710 billion. As in the case of commercial lending, it is important to recognize

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[2] 65 Fed. Reg. 36903 (June 12, 2000).
[3] 65 Fed. Reg. 36,904 (June 12, 2000).
[4] After September 11, 2001, each of the agencies issued very similar announcements encouraging their institutions to work with borrowers experiencing temporary financial hardship. For example, the OCC urged national banks "to exercise prudent efforts to make credit available and to adjust or alter terms on existing loans for customers affected by this disaster and related problems. Such prudent efforts to work with borrowers should not be subject to bank examiner criticism.

The OCC encourages national banks to consider various alternatives that may include:
extending the terms of loan repayments;
restructuring a borrower's debt obligations; and
easing credit terms for new loans to certain borrowers, consistent with prudent banking practice.

* * *

The OCC notes that these measures could help borrowers recover their financial strength and enable them to be in a better position to repay their debts. These recovery efforts can contribute to the health of the local community and the long-term interests of the national bank and its customers."

the relationship between supervisory efforts to reduce credit risk and the resulting effect on lending and related economic activity. These effects are particularly important in times of economic stress. For example, in discussing commercial lending, Federal Reserve Chairman Greenspan has referred to government programs as having unintended business cycle effects, describing the process as follows:

> "As cyclical imbalances inevitably develop, the typical pattern has been an evaporation of optimism among lenders and asset holders and a herdlike propensity to seek an increase in risk premiums. As the economy deteriorates, fewer projects seem attractive as more of the previously extended credits become nonperforming. Cautious voices, including those of the supervisors, become prominent, now supported by the increasing evidence of deterioration. In such a situation, the supervisors call for more charge-offs and higher capital. Credit becomes less available, and risk spreads widen, adding to the pressures for a further business contraction."

Just as in the case of commercial lending, calls for more conservative practices for credit card lending in response to real or perceived economic conditions can lead to reductions in credit that feed the very problem that triggered this response. We believe that the Guidance is an overly harsh response to problems with a few lenders, and urge the agencies to carefully reconsider the probable consequences of adopting the Guidance as written.

II. Specific Comments

Applicability of Guidance

As discussed in the general comments, the Guidance will require significant changes in MIS and operational procedures, the implementation period for which will differ for each lender. Nonetheless, we believe that the Guidance should set a prospective date certain at which the Guidance will apply to all institutions. That date should be sufficiently in the future to allow adequate time to address the implementation issues raised by the final Guidance. We further discuss these implementation issues in the final section of this letter.

Account Management, Risk Management, and Loss Allowance Practices

Credit Line Management

We agree with the spirit of the Guidance regarding credit line management. We have concerns, however, regarding the apparent requirement that all "credit line assignments should be preceded by evaluation and documentation of the borrower's creditworthiness." This is one example of the apparent shift from a portfolio supervisory process to an individual borrower supervisory process. Given the large number of customers of the major credit card issuers, as well as the number of times each customer might request a change in credit limit, preparing and maintaining formal written documentation of each credit line increase decision would be a significant administrative and cost burden that appears to offer no counterbalancing benefit to examiners in reviewing and evaluating the credit-line-increase decision process. We therefore recommend that the agencies instead provide that "well documented policies, procedures and guidelines outlining the circumstances and conditions under which credit line increases will be granted (e.g., minimum credit score necessary), accompanied by an electronic record of the approval of the credit line increase based on the guidelines, will be sufficient to meet the requirements of the Guidance."

Over-limit Practices

The agencies would virtually prohibit over-limits on subprime accounts. The ABA and the CPC believe that the agencies should instead seek to craft guidelines regarding over-limit practices consistent with those regarding credit line management, focusing on testing, analysis and controls, as well as a prudent evaluation of an individual customer's creditworthiness. With these proposed changes, we seek to avoid an overly draconian result in which examiners will default to the most conservative possible reading of the Guidance by mandating blanket prohibitions on over-limit authorizations. Past experience suggests that examiners have no incentive, and thus are not inclined, to utilize their discretion to interpret any guidance flexibly. Under the agencies' wording, individual examiners will likely choose to require institutions to prohibit over-limit authorizations under any circumstances. There are significant problems with that result.

First, there are significant legal barriers to the implementation of the Guidance. Both VISA and Master Card provide in their rules for "floor limits" below which no authorization is required. One example provides that Maximum Authorized Floor Limits, which unless otherwise specified, are $50 for all merchants. Further special floor limits range from $0 for non-card-present transactions, such as Mail/Phone Order Sales and cash or quasi-cash transactions, to limits such as: Railroads: $150; Regular Hotels/Motels: $500; Hospitals: $300; Car Rental Companies: $250; and Restaurants: $150. Merchants and/or their acquiring banks are free to set floor limits lower or higher than these limits, but, if higher, they take the risk of a chargeback. Thus the Guidance appears to place credit card lenders in the position of either not following the Guidance or violating their contractual commitments with merchants and card processors.

Second, there are operational considerations. Credit card transactions are authorized on the basis of a running account balance that takes into consideration payments and other credits that have been posted to the account, charges and other debits that have been posted, and charges to the account that have been authorized. A significant number of requests for authorization from hotels, rental car companies, and gas stations/auto repair facilities are submitted for estimated amounts that very frequently exceed the amount of the final transaction. For example, when a consumer rents an automobile for three days, the rental company submits an authorization for their approximation of maximum costs, including the basic daily rental fee plus taxes, insurance, fuel, etc. If the consumer's plans change and the car is returned early, even by a few hours, the actual charge can be considerably less than the original estimate. This results in available credit on the consumer's account being blocked needlessly until the estimated and actual charges are identified and reconciled in the issuing bank's systems, a process that could take days, if not weeks to conclude, depending upon circumstances, to the detriment of both the consumer and the creditor.

Third, the prohibition on negative amortization is too rigid. While we concur that it is generally a prudent business practice to limit negative amortization in subprime portfolios, a flat prohibition on negative amortization would not be feasible or recommended. Situations may arise where, for example, a subprime account goes into negative amortization for a short period of time due to interest and fees charged during a particular month, especially during the month an annual fee is assessed. Negative amortization should be evaluated based upon the activity of an account during a reasonable period of time rather than a single month, as the latter could result in the arbitrary termination of accounts, to the detriment of both banks and customers. Furthermore, financial risk is mitigated when the creditor appropriately reserves for principle, interest and fees.

In addition, we believe that creditors should have flexibility in defining minimum payment formulas so long as the result is the continued pay-down of the overlimit amount and no new authorizations are permitted until the balance is below the credit limit. Such an approach will address negative amortization concerns while avoiding a regulatory requirement mandating the entire overlimit amount be paid at once. We are concerned that such a mandate may force borrowers, who are otherwise able to pay the minimum amount due and continue to pay-down their balance, into premature delinquency and charge-off.

Fourth, the result of the limitations of the Guidance is anti-consumer. The ability to offer over-limit authorizations in certain circumstances under a prudent and carefully managed program is a vital and important customer relations tool. Good customers who typically represent low credit risk may find themselves in emergency situations in which they require additional credit availability or may be unnecessarily embarrassed by a public declination of an attempted transaction. Credit card issuers recognize that refusing to authorize transactions can have significant negative consequences for a cardholder, ranging from embarrassment at not being able to pay a bill in a restaurant to serious inconvenience if, for example, a card holder is precluded from getting a hotel room because the payment that they mailed has not yet been credited to the account when the authorization is requested. These scenarios clearly create a poor customer value proposition and yet offer no significant counterbalancing justification for or benefit to the institution from a risk mitigation perspective. Furthermore, a prohibition on discretionary over-limit authorizations may have a detrimental impact on risk management, and thus safety and soundness, by encouraging institutions to grant higher credit lines as an initial matter, or by placing responsible institutions in a position to lose otherwise good customers to competitors offering higher lines.

Therefore we recommend that Guidance be rewritten to read:

> "The policies of subprime lenders should ~~prohibit or severely~~ restrict over-limit authorization on open-end subprime accounts **to instances where clear and prudent guidelines regarding over-limit ceilings and circumstances in which over-limits will be authorized have been established and documented**. The objective should be to ensure that the borrower remains within prudent~~, established~~ credit limits that increase the likelihood of responsible credit management."

Workout and Forbearance Practices

Repayment Period –

ABA and the CPC believe that the agencies have made a significant change in the Policy in setting an arbitrary limit on the life of a work out. While we agreed that workout programs should be designed to maximize principal reduction, we believe that the agencies are in error when they assert that "debt management plans developed by consumer credit counseling services generally strive to have borrowers repay credit card debt within 48 months." We are particularly concerned that the suggested guideline of 48 months will be adopted by examiners as a "bright-line" requirement in all cases. As with the discussion of over-limit practices, above, history suggests that specific thresholds, when contained in guidance, are implemented as rules, even in cases where the guidance expressly states that they are merely designed to be utilized as informal benchmarks. This appears to be another example of a move away from portfolio supervision to individual borrower supervision that will be unnecessarily restrictive and anti-consumer.

We believe that it would be far more appropriate for each institution to be allowed to set the parameters of acceptable debt management plans based on the institution's own experience history with such plans. Institutions should retain the ability to address each consumer's individual needs and circumstances, so long as the solution adopted is prudently managed over the entire portfolio and fully supported by compelling, documented evidence. Therefore, ABA and the CPC recommend that the agencies delete the specific limitation of "48 months" and substitute instead "reasonable and prudent timeframes."

<u>Settlements</u> –

With respect to the Guidance on settlements, we believe that the agencies are in fact requiring an early recognition of loss on an individual borrower basis rather than assessing the adequacy of the ALLL on a portfolio basis. Settlement offers may or may not be accepted, may or may not be contractually paid, and even may be revoked and collection of the full amount owing be instituted. We suggest that an institution which currently has allowances built in to fully cover settlement losses should not also be required to change its charge-off recognition practices to classify losses or create specific reserves at the time of the settlement offer. We believe that under these circumstances, an institution should assess actual loss, if any, after the final settlement payment is received.

Loss recognition as suggested by the Guidance on an individual borrower basis poses significant operational issues in making required changes to the loss recognition process. Additionally, this early recognition of loss would appear to harm the consumer by actively discouraging credit card lenders from using early settlements offers, since the Guidance establishes such a high loss recognition cost for making such offers. However, if the agencies do insist upon this change, we urge that the agencies clarify that any charge-off recognition of unsettled balances should not be required prior to a restructuring of the account. Further, any early charge-off recognition for unsettled balances should be on a going-forward basis. It would be extremely difficult to implement this change operationally on a retroactive basis.

Income Recognition and Loss Allowance Practices

<u>Accrued Interest and Fees -</u>

The Guidance states that "[a]lthough regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual based on delinquency status, the Agencies expect all institutions to employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectable fees and finance charges or placing delinquent and impaired receivables on nonaccrual status." This appears to be a significant operational change. The primary reason that the agencies have <u>never</u> required credit card loans to be placed on nonaccrual status for fees and interest has been that the agencies did not consider uncollected fees and finance charges material, since the agencies recognized that these consumer loans are managed on a portfolio basis <u>and</u> that an account delinquency of 180 days required charge-off. Requiring credit card lenders comply with the Guidance by creating "loss allowances for uncollectable fees and finance charges or placing delinquent and impaired receivables on nonaccrual status" is a significant change in the Policy. We believe that there are several problems created by this approach. First, due to the potential segregation of the loss allowance into a "principal allowance" and a "revenue allowance," comparability with prior periods would potentially be distorted. Consequently, certain prior year amounts would need to be reclassified to conform to the "new" presentation to ensure comparability. To do this will require development of considerable MIS and a complete rebuild of roll-rate migration for the individual components (principal, interest, and fees). System revisions of this magnitude will require significant time to implement. Second, since this guidance is specific to credit card lending, practices for other consumer lending products in the same financial institution will now be inconsistent.

With respect to the application of the Guidance to over-limit accounts and workout programs, current loss allowance adequacy models utilizing balances and roll-rates implicitly contemplate the performance of over-limit accounts and accounts in workout programs. If an issuer were to change minimum payments to include over-limit amounts, the loss allowance calculation must be adjusted accordingly. This results in requiring explicit calculations for over-limit accounts and accounts in workout, in turn, would require development of considerable MIS and building of roll-rate migration models for the specific workout programs and over limit accounts. As noted above, system revisions of this magnitude will require significant time to implement. In both cases, the Guidance does not appear to provide for the necessary implementation time.

<u>Recovery Practices -</u>

We believe that the provisions relating to recovery practices under the topic Income Recognition and Loss Allowance Practices constitute a "fatal flaw" of this proposal. The Guidance would require that "[c]onsistent with regulatory reporting instructions and generally accepted accounting principles, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that an amount reported as a recovery on a loan is limited to the amount previously charged off against the ALLL on that loan."

As an initial matter, the industry has been allowed to take gross recoveries as an offset of charge-off for a very long time. The current means of reporting recoveries over the portfolio has been universally and consistently applied by the industry for many years, and has historically been wholly consistent with generally accepted accounting principles. Adopting a different standard for regulatory accounting purposes would be, at a minimum, confusing and burdensome, and would likely not achieve the goal of the agencies for greater transparency and comparability of credit risk across all issuers.

First, the proposed treatment of recoveries would create a significant disparity in the treatment of recoveries of loans that are collected in-house by an institution and those sold by the institution to third parties, which would be accounted for under current GAAP. The justification of, or purpose for, this disparate treatment is unclear. The proposed change appears to create unnecessary and illogical disincentives for institutions to collect their own bad debts because the Guidance imposes significant reporting burdens, including the costs required to implement such reporting, for debt collection. Under the Guidance, the more efficient a lender is at recoveries, the more onerous the reporting requirements become, as that lender attempts to allocate collections among the different categories. In contrast, if a lender collects very little, it would theoretically take that lender less time to allocate a small amount. As a result, the Guidance creates an incentive for all lenders, even those who have developed efficient collections departments, to simply sell the loans at a discount. Such sales will particularly disadvantage those lenders who have already invested in and successfully developed their collection operations, as the sale price will simply reflect a market price based on delinquency and other factors related to the portfolio, rather than the amount the lender may have collected internally.

However, if the Guidance were to try to make the treatment of debt sold consistent with the treatment of debt collected internally, difficulties arise in trying to identify components of the balance (principal, interest and fees) when charged-off accounts have been sold in bulk (one price for a pool of accounts) or are placed with agencies requires a defined hierarchy to ensure the consistent application of recovery payments to principal, interest, or fees.

Additionally, most, if not all, credit card lending institutions currently do not have the technical capability to track collections in a segregated manner – i.e., distinguishing between cash collected against principal, interest and fees as separate categories. Creating this capability will be costly in both time and resources, and is likely to produce information of questionable value to regulators and investors. The implementation would be extremely burdensome and would need to be considerably delayed due to the significant MIS required, both in-house and with vendors.

Further, as this Guidance would apply only to credit card accounts and not to other consumer loans that are not required to be placed on nonaccrual, it would result in inconsistent accounting within financial institutions that appears to be more confusing rather than transparent to investors and regulators.

Finally, the agencies do not appear to be suggesting that, on a portfolio basis, any institution is actually recovering more through the ALLL than is being provisioned, but rather the agencies seem to be concerned that some individual loans might be viewed as such. As noted above, the current practice was instituted primarily because additional detail was not material. Recoveries are typically less than 10% of principal charge-offs, and allocating the ten percent recovered among principal, interest and fees seems onerous from a materiality standpoint. Finally, at least among CPC members, situations where recoveries exceed charge-offs are extremely rare. We continue to believe that the Guidance will be extremely burdensome, is not required by GAAP, and does not result in a material change so as to necessitate adoption. We urge the agencies to not adopt this section of the Guidance.

III. Items Needing Additional Clarification

Clarifications Requested

Transition and Implementation Provisions

First, we note that the objective of several aspects of the Guidance, including provisions dealing with credit line management, over-limit practices, and settlement practices, is the adoption of account management strategies that the agencies believe maximize safety and soundness. However, we are concerned that the Guidance itself lacks the flexibility for institutions to actually identify and implement such strategies. Identifying the optimal strategy to, for example, maximize recoveries on settled accounts or minimize charge-offs on a portfolio of over-limit accounts is a complex undertaking that may require the testing of strategic alternatives on segregated populations of customers. Some will work and some will not, but nothing in the Guidance suggests that institutions will be allowed to try different alternatives in order to test them. We urge the agencies to clearly encourage examiners to work with institutions to develop implementation plans that accommodate reasonable timetables for empirical testing of practices that best achieve the purposes of the Guidance.

Second, the Press Release accompanying the Guidance states that "[t]he agencies recognize that some institutions may require time to implement changes in policies, practices, and systems in order to achieve full consistency with the credit card guidance. Such institutions would be expected to work with their primary federal regulator to ensure implementation of needed changes as promptly as possible after the issuance of the guidance." As we have demonstrated, the Guidance underestimates the significance of the proposed changes as well as the time and resources needed to make them. Several members of the CPC provided estimates of the cost and time necessary to implement the proposed changes. The consensus estimate of costs for a large credit card company was roughly $10 million dollars. More importantly, the estimated time for implementing the necessary system changes was fairly uniformly six months for most of the changes but was a full year for implementing a segregated loan system as outlined by the Guidance.

The Guidance itself makes no mention of specific implementation periods or transition issues. We believe that the Guidance must contain specific guidance for examiners on the time frame for implementation and must encourage further flexibility in examiners in considering an individual institution's ability to implement these changes. Further, while we know that the Guidance underestimates how long it would take institutions to make the systems changes necessary to implement the Guidance, we can not recommend a specific implementation period until we know what the provisions of the final Guidance will require (as indicated above, given the additional time necessary to implement a segregated loan system). Obviously, the greater the changes, the more time will be needed to implement them.

Finally, we urge the agencies to make clear that the application of all changes will be prospective only. Retroactive application would not only severely impact existing accounts and customers but also would add enormously to the overall expense in achieving compliance.

Conclusion

The American Bankers Association and the Card Policy Council sincerely appreciate the opportunity provided by the agencies to comment on this draft Guidance. However, we believe that the time allowed by the agencies is inadequate for a full consideration of all of the issues raised by the Guidance. Nonetheless, we have strived to identify the significant issues and concerns that the Guidance poses to credit card lenders; and if the agencies have any questions about these comments, please call Dawn Causey, Staff Director, ABA's Card Policy Council, at 202-663-5434 or the undersigned.

Sincerely,

Paul Alan Smith

Paul A. Smith