Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1038
September 2005

August 16, 2005

Subject: Credit Risk and Capital Charge for the Government Card Program

Dear **[ ]**:

[*Mr. A*] asked for our views on the appropriate capital treatment for unused portions of lines of credit (unused lines) on credit cards issued by the **[ ]** (**[*NB*]**) to Federal employees (hereinafter, **[*NB*]** letter).[1] In the **[*NB*]** letter, **[*Mr. A*]** suggested that the OCC should not impose a capital charge on the unused lines because the bank has an unconditional right to cancel the accounts. In the alternative, he argued that, even if the cards are not unconditionally cancelable, historic loss data do not support a 50 percent conversion factor.

We conclude that the unused lines are not unconditionally cancelable, within the meaning of our risk-based capital rules, but that the OCC will use its reservation of authority in 12 C.F.R. § 3.4 to assign a zero percent conversion factor to the lines. This reflects our conclusion that a zero percent conversion factor more appropriately reflects the credit risk to **[*NB*]** associated with the unused lines.

DISCUSSION

Background

[*NB*] is under contract with the General Services Administration (GSA) to provide purchasing, travel, and fleet charge cards to government agencies and employees as a payment tool for official government purchases and travel expenses.[2] Under this program, cards held by individual employees are defined as "individual liability accounts" (ILAs). Liability for all charges and fees incurred on ILAs rests solely with the cardholder, and the government bears

[1] Letter from **[*Mr. A*]**, Deputy General Counsel, **[*NB*]**, to **[ ]**, Examiner-in-Charge (January 21, 2004).

[2] *See* GSA SmartPay Master Contract (SmartPay Contract).

no secondary liability. Cards held by agencies are "central liability accounts" (CLAs) and are a liability of the United States.[3]

Federal employees may use their cards for official travel charges only and must pay off the balance each billing cycle. As stated in the **[*NB*]** letter, the ILA cards were not intended to be revolving lines of credit and, therefore, bear no interest. Employees are responsible for paying their accounts, although the government may offset delinquencies against an employee's paycheck.[4] Employees also have the option to authorize their agency to pay ILA card balances to **[*NB*]** directly under the Federal split disbursement and direct pay program. For **[ ]** (***Agency***) employees, the agency must directly pay all approved invoices to **[*NB*]**.[5]

Under the GSA contract, **[*NB*]** has the right to cancel an ILA if: (1) the account has been suspended two times during a 12-month period because the accountholder failed to timely pay his or her bill for undisputed amounts and the account is past due for a third time; (2) the account is past due for 120 days or more from statement closing for undisputed amounts; or (3) the accountholder uses the card for unauthorized purchases. **[*NB*]**'s ability to cancel an account, however, is not absolute; *agencies retain the contractual right to direct* **[*NB*]** *to keep an employee's account active if the agency determines that there are "mission-related extenuating circumstances*." Although the term "mission-related extenuating circumstances" is not defined in the GSA contract, some agencies have explained its meaning. For example, according to **[*NB*]**, under the **[*Agency*]** contract, the concept of "mission related" is defined as "mission critical," which in turn means "travel performed by **[*Agency*]** personnel under competent orders and performing duties that through no fault of their own, may prohibit the prompt payment of their outstanding travel charge card bills."[6]

Analysis

The OCC's risk-based capital rules are intended to primarily mitigate credit risk. Under the capital rules, a bank must convert unused portions of retail credit lines to an on-balance sheet asset and risk weight the converted asset. If the unused portion of such a commitment is "unconditionally cancelable by the bank in accordance with applicable law," then the unused portion is subject to a 0% on-balance sheet conversion factor.[7] As a result, there is no capital charge on the unused portion. "Unconditionally cancelable" means, with respect to a commitment-type lending arrangement, that the bank may, at any time, with or without cause,

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[3] As stated in the **[*NB*]** letter, approximately 46% of the $6.5 billion "annual spend" on these cards is through ILAs, while 54% of this amount is through CLAs. *See* **[*NB*]** Letter at 2.

[4] *See* 31 C.F.R. § 285.7 (describing the salary offset provisions).

[5] **[ ]**
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[6] **[*NB*]** letter, *supra*, at 5.

[7] 12 C.F.R. Pt. 3, App. A § 3(b)(4)(iii).

refuse to advance funds or extend credit under the facility.[8] If the unused lines are not unconditionally cancelable, then the bank must apply a 50% conversion factor to the unused portions of commitments to extend credit.[9]

In the preamble to the rule adopting this provision, we clarified that the phrase "in accordance with applicable law" refers to state laws that require notice before cancellation of credit card accounts. *See* 54 Fed. Reg. 4168, 4174 (January 27, 1989) (discussing treatment of retail credit arrangements). Our intention, as expressed in the preamble, was to avoid penalizing banks that operate in states with notice requirements given that, after notice, the banks could proceed with cancellation. Specifically, the preamble notes:

> Commenters also recommended that open-end credit arrangements should receive a conversion factor of 0% to the extent they are unconditionally cancelable "in accordance with applicable law." In an effort to avoid inequities that could arise in states that have notice requirements before such credit arrangements can be cancelled, the OCC has adopted the recommended phraseology. However, to the extent state law makes open-end retail credit arrangements practically uncancelable, these items will be treated as long-term commitments and receive a credit conversion factor of 50%.

Id.[10]

In the **[*NB*]** letter, **[*Mr. A*]** argued that ILA accounts are "unconditionally cancelable," notwithstanding that the bank must receive permission from the agency before canceling an ILA account. **[*Mr. A*]** characterized this step as the equivalent of a notice requirement. As a corollary, he argued that an agency's ability to delay cancellation of "mission-critical" accounts does not make the accounts "practically uncancelable."

The contractual language does not support a conclusion that the ILA accounts are unconditionally cancelable. Under the terms of the contract, the Federal agencies have the unqualified right to block the cancellation of an ILA when an employee is on a "mission critical assignment." The need to obtain agency permission to cancel a contract is not the equivalent of the notice requirement the OCC contemplated in drafting the regulation. We understand that notice requirement to be a procedural step that does not affect the bank's ability to ultimately cancel an account. In this case, although notice is given to the agency, the bank cannot proceed unfettered to cancel the contract; the agency still retains the right to block the cancellation of the account. Also, under the agreement, **[*NB*]** may cancel an account only *if* one of three specific

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[8] 12 C.F.R. Pt. 3, App. A § 1(c)(34).

[9] *Id.* App. A § 3(b)(2)(ii).

[10] The applicability of particular state notice requirements to a national bank is not at issue here and, accordingly, we do not address it. We note, however, that whether a particular state notice requirement applies would be appropriately analyzed under the OCC's preemption rules and the underlying Supreme Court precedents. *See* 12 C.F.R. § 7.4008(d)(2) (non-real estate lending; state law limitations concerning the terms of credit).

circumstances exist: (1) the account has been suspended two times during a 12-month period for failure to make timely payments and the account is past due for a third time; (2) the account is past due for 120 days or more from statement closing; or (3) the accountholder uses the account for unauthorized purposes. Accordingly, the right to cancel an account is not "unconditional."

Notwithstanding that the accounts are not unconditionally cancelable, the OCC may assign a 0% conversion factor to the unused portion of the ILAs if a 0% factor best reflects the credit risks associated with them. The OCC's regulations contain a reservation of authority that allows the OCC to look to the substance of a transaction and depart from the specific provisions of the risk-based capital guidelines if the assigned risk weight or credit equivalent amount or conversion factor for any off-balance sheet item "does not appropriately reflect the risks imposed on a bank."[11] In such cases, the OCC "may require another risk weight, credit equivalent amount, or credit conversion factor that the OCC deems appropriate."[12] The use of a 50% conversion factor for an off-balance sheet item reflects an assessment that a certain amount of credit risk is associated with the exposure.[13] We believe the specific factual circumstances presented in the **[*NB*]** letter support the conclusion that the credit risk associated with the unused ILA lines is better reflected by a 0% conversion factor.

In the GSA SmartPay Program, agencies infrequently use their ability to veto the bank's cancellation of an ILA. As noted in the **[*NB*]** letter, agencies have historically denied only two or three account closings per quarter, out of 30 to 45 per quarter closed for default or unauthorized activity.[14] That only one or two accounts per quarter must remain open, notwithstanding the bank's judgment that it should be closed because of a perceived credit risk or unauthorized activity, supports the conclusion that the 50% conversion factor does not reflect the appropriate level of credit risk.

[*Mr. A*] also submitted data showing a significantly lower loss rate for government cards. As a matter of policy, the OCC ordinarily places only limited reliance on actual, historical loss data as a basis for assigning a different risk weight or credit conversion factor than our rules prescribe. Here, however, it appears that demonstrably lower loss rates are in large part attributable to the unique character of the GSA Smart Pay program. The key distinguishing features of the program are: (1) the purpose of the program is to facilitate the operations of the Federal government; (2) the ILA cards can only be used for government purposes, in contrast to unsecured consumer credit cards, which can be used for any purpose and still qualify for a 0% conversion factor (if they are unconditionally cancelable); and (3) though individual borrowers are responsible for repayment, the amounts charged to the card will ordinarily be reimbursable

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[11] 12 C.F.R. § 3.4(b).

[12] *Id.*

[13] *See* 53 FED. REG. 8550, 8552 (March 15, 1988) (noting that off-balance sheet credit risk weighting is "based primarily upon broad judgments of relative credit risk.")

[14] **[*NB*]** Letter, *supra*, at 5.

because the charges are incurred in connection with a Federal employee's performance of his or her official duties.

The Federal purpose, limited use, and Federal reimbursement features of the ILA cards distinguish them from ordinary consumer credit cards and should substantially reduce the credit risk associated with them. The loss data provided in the attachment to the **[*NB*]** letter bear out that conclusion.[15] Given that the Smart Pay program is distinguishable from all or most other card programs, reliance on loss data here does not obligate us to consider it for other non-governmental programs. Moreover, according to the information provided in the **[*NB*]** letter, the reasons for the Federal government to require an account to remain open when there is a contractual reason to close it do not necessarily involve deterioration in the Federal borrower's creditworthiness. For example, under the **[*Agency*]** contract as the **[*NB*]** letter describes it, "mission critical extenuating circumstances" result from the performance of duties that may preclude the borrower from making timely payment of his or her bill. No inference about a change in the creditworthiness of the borrower can necessarily be drawn from those circumstances.

Further, in the case of **[*Agency*]**, the special government pay program further substantially reduces the bank's exposure to credit risk. As noted above, under this program, **[*Agency*]** requires its employees to use the Federal split disbursement and direct pay program. In this situation, once an employee submits his or her travel voucher, the government will pay the amount due directly to **[*NB*]**. In addition, employees may only use the card for travel purposes and may not carry a balance beyond one billing period.

In sum, we believe that, based on the facts presented in the **[*NB*]** letter concerning the credit risk associated with ILAs, the 0% conversion factor should apply to the unused lines. This determination is made specifically under the facts presented in the **[*NB*]** letter and may not be relied on for determining the risk-based capital treatment of any other scenario or for determining the risk-based capital treatment of any components of the government card program other than unused lines. We trust that the foregoing is responsive to **[*NB*]**'s request.

Sincerely,

/s/

Tommy Snow
Director, Capital Policy

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[15] *See* **[*NB*]** Letter at Appendix B (comparing annualized loss rates per quarter of the government and consumer card programs). According to **[*Mr. A*]**'s letter, the annualized loss rate for the government card program has been "consistently and significantly lower" than the loss rate for its general consumer card program. *See id.* at 6. Going forward, **[*Mr. A*]** stated that **[*NB*]** expects the program to have a credit loss of approximately **[ ]** basis points, which he asserted will continue to be below the expected loss rate for **[*NB*]**'s general consumer card program. *Id.* As with general consumer card programs, we believe the 100% risk weight applicable to *drawn* ILA balances should provide a sufficient risk-based capital requirement.