INTRODUCTION

Credit card lending is a type of revolving unsecured credit accessed by the borrower when purchasing merchandise or obtaining cash advances. Credit card operations include numerous activities that can be separated and performed by more than one contractor. A savings institution may perform some or all of the followings functions:

- Solicit cardholders;
- Underwrite and establish credit lines;
- Issue cards;
- Solicit retail merchants and others to accept cards;
- Establish limits for merchant authorizations;
- Establish networks for cash advances;
- Process merchant transactions to customer accounts;
- Send monthly statements; and
- Perform collection activities.

Types of Credit Card Operations

An institution may be involved in a credit card plan in one of three ways: as agent, sublicensee, or licensee.

Agent. This is the most limited form of participation. The institution receives credit card applications from customers and sales drafts from merchants and forwards such documents to licensees (described below). The institution is accountable for the documents during the process of receiving and forwarding the applications.

Sublicensee. The institution maintains accountability for credit card loans and merchants' accounts. It may also maintain its own center for processing payments and drafts and embossing credit cards.

Licensee. A licensee performs the functions of a sublicensee, and in addition may perform transactions processing and credit card embossing services for sublicensees. The licensee also acts as a regional or national clearinghouse for sublicensee institutions.

Components of Income

Credit card operations generate income in various ways. First, the institution can collect fees from borrowers for annual membership and for cash advances. It also collects fees from merchants for deposited transactions and for the use of imprinters. Interest income is collected from cardholders for outstanding credit balances; fees are also collected from other institutions for providing processing services.

Credit card lending is a high-overhead operation due to various factors, including:

- The high volume of transactions;
- The cost of credit analysis compared with the average balance outstanding;
- The cost of monitoring and controlling the use of the credit line; and
- The cost of collections and charge-offs.

The institution must establish adequate cost accounting and cost control systems to achieve and maintain profitability of the operation. The institution must perform a comprehensive risk/return trade-off analysis whenever changes in underwriting standards or other critical factors are contemplated.

Credit Card Risks and Controls

Credit card advances are loans and should be evaluated as such. Policies, procedures, and controls designed to minimize credit risk should be similar to those for other consumer loans. (See the Thrift Activities Regulatory Handbook Section 217, Consumer Lending, for more details.) But credit card lending is also characterized by unique risk factors.

As with any open-end form of consumer credit, institutions must establish credit limits for individual customers. The nature of credit card loans presents an additional risk because institutions can exert only limited control over paydowns or the acquisition of additional cards by the borrower. As a result, the borrower's debt can pay off or accumulate beyond control anytime.

The greatest risk involves the screening of applicants since most losses occur with new account holders. More seasoned portfolios typically experience much smaller losses. Adequate screening of applicants reduces the risk of both default and fraud. Institutions should follow the same screening procedures as used for other types of unsecured consumer credit, including: the applicant's credit history, job stability, and ability to pay. Given the need for comprehensive screening procedures, the mass marketing of preapproved cards without credit underwriting is inconsistent with sound underwriting and substantially increases the risk of borrower default and fraud.

Credit underwriting requires the constant analysis of data comparing the payment patterns and revenues from various groupings of accounts to determine current controllable risk factors. Credit limits and marketing efforts must consider current risk factors to control portfolio credit risk. Prescreened mailing lists should be sampled and tested for compliance with underwriting criteria before mass mailing.

Institutions may wish to consider the use of special credit reporting houses for applicant information and reviewer training. In addition, losses that do occur should be reported in a manner that identifies the underwriter who approved the line of credit and the underwriting criteria followed, such as credit-scoring systems used or specific underwriting factors of the borrowers. The regulator should evaluate not only the policies and procedures to prevent losses, but also the strength of internal controls and operating procedures. Collection efforts must be prompt and frequent.

Credit Card Misuse and Fraud

Credit card fraud is divided into two broad areas: the misuse of credit cards and the misuse of credit. Misuse of credit cards also includes counterfeit transactions. This type of fraud occurs when merchants falsify transaction slips using real or false card numbers, or by altering the amounts on transaction slips. Counterfeit fraud also includes fraudulent telemarketing operations whereby consumers are persuaded to divulge their account numbers for "too-good-to-be-true" offers. Such schemes have cost financial institutions millions of dollars in a short time. For this reason, merchants must be carefully screened and underwritten for the amount of two month's anticipated receipts (the amount that could be lost if receipts are fraudulent). Victim fraud involves the use of another person's identification to apply for credit or the use of another person's card as identification for obtaining cash.

Institutions avert the misuse of credit cards by establishing controls that prevent employees from intercepting cards, merchants from obtaining control of cards, and customers from making fraudulent use of lost or stolen cards. These controls include: dual control of plastic blanks, embossing equipment, authorization of accounts, and undelivered cards that have been authorized and embossed; software controls to prevent access to both account numbers and personal identification numbers (PINs) or personal security identifiers (PSIs); review of merchant and borrower activity for unusual patterns and for compliance with activity limit; sending of lost and stolen card lists to merchants and rewards for capturing cards; and remote transaction authorization devices for merchants' use.

The misuse of credit also takes several forms. Shotgun fraud results when an individual floods the market with credit applications (often containing false information), hoping that several credit card issuers will grant credit. With "new i.d." fraud, an individual becomes a "new" person by using the name and social security number of someone else, sometimes a deceased person. With credit alterations, applicants delete or modify their own credit records. “Credit clinics” use loopholes in the Fair Credit Reporting Act to change credit histories of poor credit risks.

Regulatory Considerations

Due to the high volume of low-balance accounts, review of individual files for credit quality is inefficient. Instead, the regulator should first determine the adequacy of the following: policies, procedures (including underwriting guidelines and internal controls), management reports (especially exception reports), internal loan review practices, pricing policies, and charge-off policies. A review of a sample of loans to determine compliance with internal guidelines may be appropriate. If reports are determined to be accurate, classification of the assets is usually performed by applying a uniform system to the delinquent loans listed on the report(s).

The regulator’s attention should be directed toward determining the adequacy of overall systems and results. An institution will not sustain a successful credit card operation if its systems are inefficient. If individual accounts require additional personal attention by the staff, profitability will be compromised.

Credit card use is an expanding and diversifying part of the financial services industry. Regulators may find that some thrifts may be allowing customers to use credit cards with several applications: automatic teller machines (ATMs), point of sale (POS) terminals, telephone bill paying, account transfers, and debit card programs. For federal institutions, these applications are covered by § 545.141 of the regulations for remote service units (RSUs). Such uses are forms of electronic funds transfer (EFT) and require close attention to operational and systemic controls. Regulators must review related control procedures closely to determine if both customers and thrifts are adequately protected from improper use of credit cards through RSUs.

Charge-Off Procedures

The identification of unfavorable trends must include the review of past-due percentages, and income and loss trends with comparisons by underwriting criteria. Management should monitor such trends closely. Unfortunately, in thrifts that lack a well enforced charge-off program, loss ratios are often meaningless for periods of less than a year. This delays recognition and implementation of any necessary corrective action. For more information on charge-off regulations and procedures for open-end consumer loans, consult Thrift Activities Regulatory Handbook Section 217, Consumer Lending, and § 561.13 of the regulations.

Regulations Affecting Credit Cards

A number of consumer regulations affect credit card loans. Regulation Z, in particular, establishes specific rules for open-end consumer credit. Regulators need to be familiar with these regulations. They are discussed in detail in the Compliance Activities Handbook. Other memoranda and policy statements that apply to credit cards are provided in the appendices.

Accounting

The following accounting rules apply to credit card lending:

- Annual card fees should be recorded as deferred income and amortized into income over the period of time the customer has use of the card. Usually a straight-line method of amortization is used.
- Fees charged for merchant and interchange transactions are usually accrued as receivables and taken into income at the time of the transaction.
- Interest income is recognized using the level-yield method as deemed collectible.

Securitization

Securitization has become an increasingly popular method for issuers to remove credit card receivables from their balance sheet. This same approach has been used for other types of receivables, including automobiles and real estate mortgages. Securitization involves the pooling and repackaging of debt obligations into securities that can then be sold in the secondary market. The presence of a secondary market also increases the effective liquidity of an institution's portfolio. (See the Mortgage Banking Sections of the Thrift Activities Regulatory Handbook, for further information.)

An institution packages its credit card receivables into security form, then markets those securities through an underwriter or through private placement. To qualify as an outright sale, the receivables must be assigned to a third party (e.g., trustee) that has no recourse back to the institution. If recourse remains in the form of a contingent liability, the receivables are not removed from the institution's balance sheet. The spread between the yield payable by cardholders and the yield to investors goes into a reserve fund that investors may tap in case of default. As a backup, another institution may issue a standby letter of credit guaranteeing a fixed percentage of the securities. The issuer typically retains servicing rights.

When an institution is relying on the secondary market as a source of funding for the loans that are originated, the regulator should focus on determining whether the required underwriting standards are strictly adhered to. An unexpected buy-back of loans or nonfunding when expected could negatively affect operations.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(b)(4)	Credit Cards
§ 1464(c)(2)(D)	Consumer Loans

Code of Federal Regulations (12 CFR)

Subchapter B: Consumer-Related Regulations

§ 533.1	Electronic Funds Transfers Subject to Regulation E

Subchapter C: Regulations for Federal Savings Associations

§ 545.51	Credit Cards
§ 545.141	Remote Service Units

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.13	Consumer Credit Classified as Loss
§ 561.47	Slow Consumer Credit
§ 563.93	Loans-to-One Borrower Limitation
§ 563.170(c)(2)	Records Required
§ 563.170(e)	Use of Data Processing Services

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