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Household

VIA FACSIMILE (202-906-7755)

October 3, 2000

Manager
Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attn: 1550-0023

Re: Notice and Request for Comment – Proposed Changes to the Thrift Financial Report ("TFR")

Dear Sir or Madam:

Thank you for the opportunity to comment on the TFR changes recently proposed by the Office of Thrift Supervision (the "Proposal").

Background:

Household International, Inc. ("Household"), through its subsidiaries, is one of the largest consumer lenders in the country. Household's lending subsidiaries include Household Bank, f.s.b. ('Household Bank" or the "Bank"), several nationally-chartered banks, and a variety of state-licensed lenders. Since 1878, Household Finance Corporation ("HFC"), Household's largest business, has been making loans to a traditionally underserved "middle market" of consumers. While HFC's core business has not changed in over 120 years, much of this business has come to be known as "subprime" lending. Both Household Bank and its subsidiary credit card bank, Household Bank (SB), N.A., also engage in some lending activities that could, under various definitions, be considered "subprime."[1] As a result, the bulk of our concerns focus on the proposed "Schedule NL," which would require specialized reporting of loans considered "subprime" under a yet to

[1] For reporting purposes, the assets of Household Bank (SB), N.A. are consolidated with those of Household Bank. At 6/30/00, Household Bank's assets, including those of Household Bank (SB), N.A., totaled $10.9 billion.

be determined definition. Our comments on Schedule NL and several other aspects of the proposal follow.

"Nontraditional Lending"

Of significant concern to Household is the proposed, and potentially extremely burdensome, "Schedule NL" which would require detailed public reporting of "High Loan to Value Loans" and "Subprime Loans." This discussion addresses "Subprime Loans" and then "High Loan to Value Loans."

Subprime Loans:

First, we question the value and necessity of a complicated schedule that will impact less than 2% of the institutions that the Office of Thrift Supervision ("OTS") supervises. Next, there are the significant problems well outlined by the Proposal with respect to simply defining what is a "subprime" loan. Then, depending upon the final iteration of the "subprime" definition and what information the OTS seeks with respect to which loans, significant programming changes will likely be necessary to ensure accurate reporting. To meet the timeframe stated in the proposal, these programming changes would need to be completed and effective by December 31, 2000. Finally, there is the potential impact of the publication of this new schedule to the TFR.

As a result of its long history in the "subprime" market and substantial technology resources, Household and its subsidiary banks profitably provide a variety of consumer loan products to a broad nationwide customer base, increasing the availability of credit particularly to lower and middle-income individuals. While we can understand the regulatory concern resulting from a few lenders' recent, unprofitable forays into the subprime market (three[2] of which resulted in bank failures of which two had their problems compounded by fraudulent activities), the Proposal estimates that fewer than 2% of existing thrifts would actually be required to file the new schedule (estimated by the Federal Deposit Insurance Corporation to total 24 savings institutions). Despite this de minimus number of institutions actually engaged in lending that the Proposal considers potentially subprime, it notes that "there is no reliable way to regularly monitor individual institutions' subprime lending practices." This is apparently due, according to the Proposal, to the length of the examination cycle, which creates a time lag that hinders supervision. An alternative we would suggest to the costly, potentially misleading, "Schedule NL" is increased supervision of those thrifts engaged in

[2] These banks include: Bestbank, First National Bank of Keystone, and Pacific Thrift and Loan Company. See Statement of Donna Tanoue, Chairman of the Federal Deposit Insurance Corporation, Testimony on Recent Bank Failures and Regulatory Initiatives Before the Committee on Banking and Financial Services (February 8, 2000).

any lending that the OTS considers "subprime," or outside of a particular thrift's expertise. This could be managed off-site on a case by case basis, by telephone, e-mail, and other rapid types of communication without necessitating a fixed, highly complex regulatory definition of "subprime." The OTS could then take into account such intangible factors as the institution's management experience, economic conditions in its market area, capital resources, and other factors that might create an unsafe and unsound condition at one institution but not another. It is exactly the existence of such factors, which are not evident on the TFR, that could render the TFR an inappropriate, potentially misleading vehicle for managing institutional risk associated with lending to a narrow strata of retail borrowers.

In the questions it poses, the Proposal illustrates how difficult it is to define a "subprime" borrower. First, there is the general definition of "subprime loans" – "extensions of credit to borrowers who, at the times of the loan's origination, exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." At an organization like Household, our businesses are divided by product lines and features, and customers are evaluated based upon a variety of credit characteristics. Consumer loans are then originated by a legal entity that makes sense for each product – for instance, private label credit cards by a limited purpose national bank, internet-based home equity loans by our federal thrift, or auto loans by a state-chartered finance company. While there may be ends of the credit spectrum for each product that are clearly "prime" or "nonprime" (and we do have certain products that fall more into one category than the other) there is no dividing line to speak of that would tell us who is a "traditional bank lending customer." Rather, based upon product features, a combination of generic and proprietary credit scores, and a variety of other factors, we establish risk-based pricing matrices which enable us to make the most loans possible to both serve our customers and achieve our income goals. To attempt to reinstate a dividing line between who is "bankable" and who is not would be a step backwards from the perspective of credit risk management, credit availability, and equal credit opportunity.

A further issue raised by the general definition is its reliance on categorizing a loan at the "time of origination." Borrower characteristics often change over time. To label each loan based only on application data could lead to significant over or understatement of the risk in a portfolio. A critical function of risk management is the evaluation of borrowers' performance over time, which enables a lender to make changes in a product or its relationship with a borrower, or even in its underwriting criteria, to manage new risks that appear. Advances in technology have made this more feasible, resulting in new products that benefit both borrowers and lenders – for instance, the current prevalence of new loan products that change the pricing on a loan relative to change in a borrower's perceived risk profile.

We do not believe that a useful "subprime" label can be created based upon specific, individual borrower characterisics. That being said, below we have tried to address the specific questions raised by the Proposal regarding the "subprime" definition.

(1) Should subprime loans be reported on a portfolio or individual loan basis?

From a programming and reporting standpoint, we believe it would be considerably more burdensome to report on an individual loan basis. As the Proposal indicates that a loan's "subprime" status would be based upon application data (as it is measured "at the time of origination") this application data would need to correspond to the components of the final OTS definition and then be stored in a database linked to financial reporting systems. Reporting on this basis will likely over or understate an institution's exposure to alleged "subprime" lending. As an example, should the OTS adopt a "subprime" definition that uses debt-to-income ratios as a trigger, there may be well-performing high income borrowers who find their loans considered "subprime" due to an arbitrary ratio. Further analysis of these specific credit characteristics is discussed below.

Regarding reporting on a portfolio basis, because there is no indication in the proposal of how the OTS would determine which portfolios would be considered "subprime," it is more difficult to comment on this option. However, we presume that the final iteration would necessitate analysis of all loans in a single portfolio, which would be considered "subprime" in its entirety depending upon the percentage of those loans that met the "subprime" criteria. While this initial step could be quite burdensome, the overall approach may be more manageable once the portfolio has been assessed. That being said, reporting on a portfolio basis could further dilute whatever utility the schedule would have as it would by its nature under or overstate an institution's exposure to the risks identified by the OTS.

(2) The Proposal asks, based upon the proposed definition and upon our internal definition of "subprime" what percentage of our portfolio would be considered "subprime."

As mentioned above, the proposed definition is impossible to apply, as we have no definition of a "traditional bank lending customer," nor of a "subprime" customer. However, based upon the specific questions asked by the Proposal, we would guess that over half of the assets of Household Bank (a profitable, well managed, "well capitalized" institution) might currently be considered reportable on "Schedule NL."

(3) The Proposal asks what criteria we use to determine whether a loan is "subprime" and whether the criteria are the same across loan products.

Again, we do not classify loans as "subprime" or not. However, risk factors do vary across product lines. There could be no consistent definition across diverse product lines such as credit cards, real estate loans, auto loans, and unsecured loans. Each of these products will break down further into various subsets with their own features, pricing, and credit characteristics. For instance, credit card risk profiles will vary between general purpose and private label cards.[3] There are even further distinctions between how private label customers in a portfolio related to furniture retailers will perform when compared to customers of electronics retailers, so the underwriting systems are adjusted accordingly. At the same time, all of these will differ from how a home equity loan applicant will be evaluated.

(4) As the Proposal broadly defines subprime loans as those with an increased risk of default, it requests whether a number of loan features could be used as indicators of that risk.

(a)/(b) Higher loan fees and interest rates, e.g., 200 bp above a "traditional savings association customer." Fees and interest rates do help compensate for risk in certain loan products, but will vary drastically across product lines and with respect to certain loan features. Thus, they are not a good indicator of risk of default. First, there is the fundamental issue of what rate would be given to a "traditional savings association customer" on products like a cobranded credit card? A high LTV second lien home equity loan? A private label credit card for a warehouse store? All of these rates and fee structures will vary depending upon the features of the product like cobranded rewards or annual fees, and other features including the lien position of the collateral or the existence of mortgage insurance. Other factors related to loans in a portfolio such as the existence of a prepayment penalty, a balloon payment, or the lender's ability to securitize or sell that loan on the secondary market may also impact pricing. As an added note, if the pricing on a portfolio renders it reportable on "Schedule NL," the existence of that reporting requirement could actually deter prudent pricing.

[3] Our private label portfolio is held by a national bank subsidiary of our thrift and thus is reported on the TFR.

(c) Debt to income ratios. These are easily measurable, but not always a good indicator of default risk, as they can vary considerably depending upon income levels and other factors such as geographical cost of living differences and taxes. The better indicator is how much income a customer actually has available for debt payments.

(d) Delinquency history. Like the variations in credit risk across credit products, the value of delinquency history will vary depending upon what it relates to. For example, in the case of a mortgage loan, mortgage delinquency history may be more valuable than other types of credit history. There are also many borrowers who have a chronic history of minor late payments, but that cure quickly and present a minimal risk of actual default on the loan. This situation will be captured in a well-designed underwriting system.

(e) Loan to Value ("LTV") ratio. LTV is not a consistent indicator of risk of default. For instance, because mortgage interest is tax deductible, many higher income borrowers will borrow a significant amount of their properties' value for tax purposes. This does not necessarily increase the risk associated with repayment of the loan.

(f) Credit scores. We extensively use both internal and generic scores, usually together for underwriting purposes. We believe them to be the most reliable indicators of default risk. Internal scores are based upon the experience we have with particular customers and products. They vary from product to product, and are used in conjunction with other criteria (including generic scores) to underwrite loans and to assign pricing and credit lines. They are not used to assign a "subprime" status to a loan. Regarding generic scores specifically, there are many available for a variety of purposes. To choose one scoring system risks endorsing a particular company's scoring methodology for managing institutional risk.

(g) Bankruptcy Status. A customer's prior bankruptcy is not necessarily a good indicator of default risk. Individuals file bankruptcy for a variety of reasons, including catastrophic events that have little or nothing to do with their credit risk. Thus, a rehabilitated former bankrupt customer may be a better credit risk than someone who is carrying a high debt load. Also, the composition of the bankrupt population (and thus the relationship between bankrupt status and credit risk) has significantly changed in recent years as bankruptcy has become more frequent and less stigmatized. Banks and other lenders are now more willing to lend to formerly bankrupt customers, who should not be automatically defined as "subprime."

(h) Lack of Credit History. Because a customer's credit history is a valuable component in identifying default risk, a lack of credit history makes underwriting extremely difficult. Thus, it would be unusual to call such customers "prime." However, lack of credit history can be related to a variety of factors including age, immigration status, cultural biases, and marital status (a recently divorced individual may have only had credit in a spouse's name). To automatically label any such "thin-file" customer as "subprime" risks further complicating those borrowers' entry into the credit market.

(5) "Should the definition of subprime be identical for all types of loans . . . ?"

As previously discussed in response to question (3), the risks associated with various types of consumer lending can vary considerably. Thus, a uniform definition of "subprime" across product types would not appear to be a useful instrument for identifying portfolio risk.

(6) Can we identify whether borrowers with subprime characteristics have credit support? Are such borrowers considered subprime?

We can determine, on a loan by loan basis, whether certain borrowers have various types of credit support such as a cosigner or insurance. Depending upon the product, the borrower, and the type of credit support, that credit support may affect the underwriting of the loan. However, there is no firm rule that any one of these supports would necessarily convert a borrower to "prime."

(7) How should the agencies take into account shifts in the definition of "traditional" lending?

This question only further highlights the difficulty in creating a definition of "subprime" that can be used for systemic reporting purposes. It also further underscores the uncertain utility of any such information that is gathered. As far as we are aware, there are no consistent, concrete rules that define "traditional" lending. Underwriting will vary between institutions, distribution channels, geographic locations, product types, and brand names. As a practice, consumer loan underwriting has already moved away from a "bright line" test between "traditional" and "nontraditional" (i.e., customers that are "bankable" or not) to more sophisticated credit scoring systems and risk-based pricing. As technology continues to develop, underwriting systems will as well.

(8) "Should the subprime loan definition distinguish between institutions that target higher risk borrowers as opposed to those institutions that serve a community in an economically disadvantaged area where the repayment ability of area borrowers can be or has been adversely affected?"

If the purpose of the new schedule is to monitor the growth of certain portfolios carrying a specific type of credit risk, there should be no distinction between such institutions. That being said, we do share the fear that appears to be the underlying premise of this question – that the new schedule risks causing further disadvantage to borrowers who may already face barriers to entry into the more mainstream credit markets. However, there should be a consistent purpose and approach to the schedule – if it is to measure a certain type of risk, it should be used to report products that meet the OTS' criteria for carrying that risk. Our institutions serve a wide variety of borrowers, including those in economically blighted areas. Our experiences with credit scoring support a uniform approach, as they show that borrowers in diverse locations with similar profiles will behave similarly.

(9) Should there be a de minimus level of subprime loans below which reporting is not required?

This would likely be necessary in the case that the OTS requires institutions to report by portfolio, as we assume (though this is not indicated in the proposal) that a portfolio holding a certain percentage of "subprime" loans would be considered "subprime." Presumably, this scenario would encompass portfolios where the "subprime" loans constituted a de minimus amount that did not represent significant increased risk to the bank.

(10) Should smaller savings associations be treated differently from larger savings associations for reporting purposes?

Like question (8), the answer depends upon the purpose of the new schedule. If it is truly to identify risk on a timely basis, it is quite possible that the risk associated with a type of lending new to a particular institution may be considerably higher at a small institution than at a larger, more diversified company. However, such smaller thrifts may have fewer resources to ensure compliance with the new reporting requirements.

(11) Should any loans be excluded from the definition of "subprime" or reported separately?

We do not believe that any specific loan type should be labeled "subprime."

(12) Should the proposed TFR items be treated as confidential for a limited period of time in order to give associations time to resolve issues surrounding which loans should and should not be reported as subprime?

Yes. Any new schedule relating to the reporting of "subprime" lending should be filed confidentially for at least two reporting periods in order for both the OTS and the affected institutions to assess the impact of the schedule as discussed below.

As difficult as it is to choose a precise definition of "subprime," we are concerned about the potential for misinformation in the public arena resulting from the publication of the new schedule. The OTS states in the Proposal that it needs the information regarding subprime loans for supervisory reasons, in order to monitor the potential increased risks in certain banks. With this public statement being made at the outset, the few banks that actually file this schedule may attract unwarranted negative attention for the information they report. These loans may provide no increased risk to a specific institution and may represent no change to the institution's management of its product lines. But there may still be negative reaction for a variety of reasons. First, there is the continuing confusion in the media and elsewhere between "subprime" and "predatory" lending. Second, there is the often implied (yet false) assumption that "subprime" necessarily involves a higher amount of institutional risk than more traditional "prime" lending, accompanied by the likelihood of higher capital costs resulting from the schedule. Third, the TFR schedule is only a snapshot of very specific data – it provides no information regarding management, economic conditions, or other risk factors affecting the institution. For these reasons, we reiterate our suggestion that the few institutions affected by this new reporting requirement be supervised on a case by case basis as needed in between scheduled examinations. If the OTS does decide to require the schedule, we suggest that it at least initially be filed confidentially so that both the OTS and the affected savings institutions can assess the impact of the new reporting requirements.

As a final note regarding "Schedule NL," we fear that its existence and its title, "non-traditional lending," risk further stigmatizing certain borrowers and loan types, potentially driving these products out of insured savings institutions. Affected institutions will essentially be required to determine who are their "traditional" customers and who are their "non-traditional" customers at the point of underwriting. If filing the schedule is viewed as a strike against an institution – either due to higher capital costs resulting from the schedule or the public impact described above – lending to "non-traditional customers" by savings banks may be curtailed. This would likely result in even higher lending costs for such consumers, who may already have limited options. We agree with the recent statement by OTS staff that "the subprime market is a well-functioning, competitive market."[4] Advances in technology and risk management have expanded, and continue to expand the availability of credit, while blurring the lines between those borrowers who might be considered "bankable" or not. We trust that the OTS and the other federal banking regulators will act cautiously before effecting regulatory changes that may well impact the functioning of that market and help reinstate outdated lines that were once drawn between borrowers.

High-LTV Lending

While recognizing the interest the OTS has in this type of lending, we question the utility of this schedule. Like "subprime" lending, the real risk to an institution lies with how the loans are underwritten and managed. Statistical data on High-LTV lending will not contain other factors surrounding a loan such as other collateral, security, or insurance. Most importantly, the LTV associated with a loan does not reflect a borrower's ability to repay that loan.

Rather than require all lenders to incur significant programming and reporting costs to assemble this information that is incomplete, but yet will be public, we suggest that the OTS require thrifts to notify their supervisory office once this type of lending reaches a certain level in relation to that bank's capital. The OTS could, if deemed appropriate, then increase its supervision of such an institution in order to manage any perceived increased risk. At a minimum, if this reporting is required, we suggest that for the first several reporting periods, this information should be kept confidential for the OTS' use until both the affected institutions and the agency can review the results and their impact.

"Home Equity Lines of Credit Outstanding"

The OTS proposes to add a line that would provide data on the balance of outstanding home equity lines of credit that have not yet been drawn down. Currently these are included with "Open-end Consumer Lines." We do not object to this information collection, but do note that it will entail programming costs and changes.

[4] Phillips-Patrick, Hirschorn, Jones, and LaRocca, Research and Analysis, Office of Thrift Supervision, "What About Subprime Mortgages?", Mortgage Market Trends, Vol. 4, Issue 1 (June 2000).

"Board of Directors' IRR Limits"

The Proposal would require disclosure on the TFR of each association's interest rate risk limits as set by their Board of Directors for the plus/minus 200 basis point rate shock scenarios. The OTS plans to use this information to identify savings associations that may be in excess of their Board limits. While we recognize the OTS' interest in this information, we consider the information proprietary and object to the proposition that it be publicly reported.

"Holding Company Financial Information"

The Proposal would add a schedule to the TFR to collect financial data on thrift holding companies, in order to "leverage its ability to collect information for the purpose of off-site monitoring." The OTS estimates that 48% of all savings associations filing the TFR would be subject to this new schedule. However, a certain percentage of those savings associations are subsidiaries of publicly-owned companies (or companies that have public debt outstanding) that are subject to the disclosure requirements of the Securities Exchange Act of 1934 and its implementing regulations promulgated by the Securities and Exchange Commission ("SEC"). These requirements include filing a quarterly Form 10-Q with the SEC, which includes the financial information requested on the proposed new schedule. These filings are readily available on the SEC website. As a result, in order to contain some of the possible burden added by the Proposal, we suggest that associations whose parent companies file a Form 10-Q not be required to also file the new schedule to the TFR. At a minimum, these companies should be entitled to file an additional copy of the Form 10-Q with the OTS, in place of the new schedule.

"Eliminating Confidential Treatment for Certain Interest Rate Risk and Past Due Data"

Currently, the OTS affords confidential treatment to information reported on Schedule CMR on the maturity and rate information used in assessing interest rate risk and information reported on Schedule PD on the amount of loans 30-89 days past due and accruing. While we do not object to public reporting of the information on Schedule PD, we do object to releasing the information on Schedule CMR. We consider this information proprietary, and see no justification for its publication. The only support the Proposal gives for this policy change is its intention "to give the public . . . more complete information." This circular argument could presumably be used for any information the OTS collects under its supervisory powers. Before the OTS makes such a determination, we suggest that there should exist a demonstrable public need for the information that outweighs any harm that could possibly be done to an institution. In this case, while a particular institution could at a particular quarter's end be in an unfavorable interest rate position, the facts underlying the scenario would not be contained in the TFR. While they could represent a serious risk to the institution, they could also reflect a very temporary aberration. Overreaction in the market is a real possibility that could drastically impact that thrift's access to market funding and the price that it is required to pay for this funding. The TFR could thus exacerbate what started out as a benign event.

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While we appreciate that the OTS is trying to leverage its ability to perform supervisory functions off-site, we are concerned about the possible market impacts and new burdens raised by this proposal. For well over a century, Household has profitably managed loans that "traditional" banks might avoid. We would encourage the OTS and the other agencies to move carefully before intervening in this well-functioning market. Moreover, the mandate that any new requirements would be effective as of January 1, 2001, for the March 31, 2001, TFR, is not reasonable, given that it is unlikely that the reporting requirements will even be finalized before November, 2000, and may require programming tasks that cannot be completed before year-end. In addition, where the OTS is changing many aspects of the TFR from a purely statistical document (for instance, by adding information on affiliate transactions), we believe that a longer time period for reporting should be allowed, for instance, 45 days rather than 30. And where, as suggested by this letter, there are simple, less onerous means for the OTS to accomplish its stated goals, we believe that the OTS should not implement a potentially burdensome, harmful proposal.

Again, we appreciate the opportunity to comment on the Proposal. If you have any questions or would like to discuss our comments further, please feel free to call me at (847) 564-7941.

Sincerely,

Martha Pampel
Senior Counsel
Federal Regulatory Coordination