XIII. ASSET QUALITY CONSIDERATIONS

Asset quality impacts many facets of bank operations and is one of the most critical factors in determining the bank's overall condition. The quality of the loan portfolio, including credit card portfolios, and of credit administration programs normally have a substantial effect on asset quality because loans are usually the largest of the asset items, and they can carry the greatest amount of potential risk to capital. Review of the credit card portfolios is carefully rolled into the comprehensive review of asset quality. Problems within the card portfolio can detract from management's ability to successfully and profitably manage other bank activities.

The asset quality rating incorporates the quantity of existing and potential credit risk associated with the credit card portfolio(s) and the ability of management to identify, measure, monitor, and control that credit risk. It should consider the adequacy of allowances for credit card losses and all other risks that may affect the value or marketability of the card portfolio, including, but not limited to, operating, market, reputation, strategic, or compliance risks. Prior to assigning the overall asset quality rating, examiners should consider several factors within the context of any local, regional, or national conditions that might impact the card portfolio and, consequently, bank performance. Also, examiners should give any systemic weaknesses appropriate consideration. The following list is not exhaustive but does provide factors to consider when determining the quality of the credit card portfolio and, consequently, asset quality:

- Appropriateness of marketing programs, the inherent risks of target markets, and the suitability of risk selection practices.
- Adequacy of credit card underwriting standards.
- Soundness of credit card administration practices, including for account management, and management's ability to appropriately establish and conduct those practices.
- Level, distribution, severity, and trend of over-limit, adversely classified, nonaccrual, workout, and other problematic credit card receivables/accounts.
- Adequacy of credit card allowances, including the ALLL and any other types of allowances.
- Diversification of the credit card portfolio, including the existence of concentrations.
- Support (or lack thereof) of any underlying collateral, the control over collateral, and other credit risk mitigants.
- Adequacy of policies and procedures for the areas of credit card operations.
- Volume and nature of exceptions and overrides.
- Level of compliance with regulatory and other credit card lending guidance.
- Adequacy of internal controls and MIS.
- Profitability of credit card portfolios or portfolio segments.
- Consideration of the impact of portfolio purchases and/or sales.
- Credit risk from off-balance sheet activity, such as unfunded credit card lines.

Factors should be evaluated not only according to the current level but also to any ongoing trends. The same level might be looked on more or less favorably depending on any improving or deteriorating trends in one or more factors.

Key indices can be beneficial in determining the quality of the credit card portfolio. If properly developed, management's basic suite of reports (usually prepared at least monthly) should be able to aid examiners in identifying most of the key indices. The reports, as discussed in the Portfolio Management chapter, should usually be prepared for each portfolio segment to help gauge performance within that segment or to the managed portfolio. Examiners also frequently develop their own reports (or spreadsheets) based on management's reports and any relevant information gathered during the examination.

SUMMARY OF EXAMINATION GOALS – ASSET QUALITY CONSIDERATIONS

Examiners must determine the quality of the credit card portfolios, including consideration of the adequacy of allowances, the quantity of credit risk within the card portfolios, and the quality of credit risk management of the portfolios. Examiners then consider that risk in the overall assessment of asset quality, which includes assessments of other asset components (for example, traditional loan portfolio and securities) as applicable. Some specific considerations to determine the quality of the credit card portfolios are listed in the bullet points earlier in this chapter. In summary, examiners should:

- Consider examination findings from the various credit card operational areas (marketing, underwriting, portfolio management, and so forth).
- Consider the level of and trend in key indices, such as those for delinquencies, charge-offs, workout programs, and so forth. This process will likely entail reviewing a series of management reports on various portfolio segments.
- Consider the level, trend, and severity of adversely classified credit card receivables.
- Consider the status of prior examination findings related to credit card portfolio quality.

Numerous potential red flags are named in preceding chapters of this manual. Examiners might identify the following situations which may be red flags from a broader perspective and warrant additional follow up, potentially in the subcomponent review areas for credit card activities:

- Existence of higher-risk programs, such as those targeting subprime borrowers and/or borrowers with no or limited credit histories.
- Concentrations, such as in subprime receivables.
- Unproven product models, or changes to the models without sufficient testing periods.
- Rapid growth in the credit card portfolio.
- Changes in underwriting standards or risk selection practices that broaden the range of the customer base to a higher-risk population.
- High or increased levels of adversely classified credit card loans.
- Increased severity of classifications.
- Less than full compliance with regulatory and/or other guidance governing credit card lending activities.
- Failure by management to address prior examination or audit concerns.
- Re-booking of charged-off assets.
- Compensation programs that fail to reinforce management’s responsibility to properly administer, analyze, and report the risk in credit card portfolios.