XVI. EARNINGS

Earnings help safeguard against the risks of engaging in the credit card business and represent the first line of defense against capital depletion. Credit card activities continue to offer banks substantial opportunities for profit. Although prosperity from credit card lending has fluctuated over the years, returns on credit cards have remained higher than returns on most other commercial banking activities.

On a bank-by-bank basis, credit card earnings vary widely based on a number of factors, such as management's expertise, products offered, the bank's risk appetite, cyclical or seasonal trends in the economy and consumer behaviors, and other happenings in the economic and competitive environments (natural disasters, regulatory or legislative issues, and so forth). Viability for banks that operate in highly competitive industries like the credit card industry is predicated on continual adaptation to the changing conditions. That requires an understanding of how various factors are affecting the bank and appropriate actions to address the impacts. Further, profit margins for credit cards can sometimes be illusory, such as if they are based on a high volume of penalty fees that have yet to be collected, on inappropriately reported gains on sales of receivables, or on unsustainable events. As such, thorough analysis of the financial performance of the credit card operations is necessary.

As is the case with other commercial banks, overall profitability for a bank conducting credit card activities should consider return on average assets (ROA), net interest margin (NIM), noninterest income as a percentage of average assets, and noninterest expense as a percentage of average assets. Examiners should also closely inspect the various income and expense categories to evaluate which subcomponents contribute positively or negatively to the bank's operations, to what degree those subcomponents contribute, and how the subcomponents are expected to impact future earnings performance. To evaluate earnings, particularly income categories, the examiner must consider, among several other factors, whether pricing of the credit card product(s) is effective.

PRICING

Pricing is a key determinant of the profitability of a credit card program. Interest rates charged on the credit cards are usually a prominent pricing component. Card issuers now offer a broad range of card plans with various rates (depending on credit risk and consumer-usage patterns) as well as differing interest charge calculation methods. Many issuers have also moved to variable-rate pricing that ties movements in the cards' interest rates to a specified index that moves with market rates. As such, interest rates on credit cards in general have become more responsive to issuers' costs of funds. But, many issuers have also attempted to gain or maintain market share by offering low, introductory rates (or teaser rates) to new customers and/or for balance transfers. Tightened margins from high quality borrowers, in part due to those practices, have led many banks to expand offerings to subprime borrowers. Interest rates on subprime credit cards are generally higher than those for prime credit cards, but with other pricing tools available to banks, this is not always the case.

Card pricing includes a variety of elements to supplement the interest rate charged. Pricing structures are increasingly comprised of a myriad of upfront, punitive, and other fees that play a pivotal role in a program's profitability. Fees within the industry include, but are not limited to:

- Annual fees.
- Cash advance fees.
- Over-limit fees.
- Late fees.

- Balance transfer fees.
- Acceptance fees.
- Program fees.
- Account set-up fees.
- Maintenance fees.
- Participation fees.
- Processing fees.

This list is not exhaustive but effectively illustrates the multifaceted fee structures that are in place in the current market. Ordinarily, subprime credit card accounts exhibit a much higher level of upfront fees than do prime accounts. Pricing structures of the credit card products and names for similar fees vary between banks. Fee sizes have grown significantly over time but, increases to many of the fees are slowing. FAS 91 addresses accounting for certain fees and is discussed under a separate heading later in this chapter.

Fee waivers are sometimes used as an account retention tool, and, as mentioned in the Portfolio Management chapter, are sometimes used as a collection tool. The volume of fees forgiven could substantially impact earnings performance, particularly on a short-term basis. However, if the fees were charged and ultimately not collected, true earnings performance would not be affected to a significant degree on a long-term basis, assuming appropriate accounting occurred.

Changes in fee assessment and waiver practices, possibly due to a bank's implementation of the AMG, might also impact earnings. The changes generally result in lower fee incidents, all other things remaining equal. A higher frequency of waived fees as well as reduced levels of over-limit and delinquent accounts results in fewer fees recorded than would have been recorded with past practices. But, if the fees that would have been assessed per past practices would ultimately not have been collected, long-term earnings performance would not be substantially affected, assuming appropriate accounting occurred.

INTEREST AND FEE INCOME

Interest and fee income includes, but may not be limited to, interest income on credit card balances reported as loans, loan origination and commitment fees, and past-due charges. Income from seller's and residual interests retained in a securitization is also reported in the interest and fee income category. Contribution of the category to the ROA typically depends on several factors, including:

- Each vintage of a product offering has inherently unique characteristics such as stated finance charges and fees. Management normally prepares profit analyses for the total portfolio and for significant portfolio segments to determine contribution to interest income.
- The greater the volume of **convenience users**, the lower the yield produced on the portfolio. Convenience users differ from **revolvers** in that convenience users pay outstanding charges in full for each billing. Banks generally benefit from convenience users due to interchange and/or annual fees, which are discussed in the Noninterest Income section of this chapter.
- The number of collections days in a month is a factor of management's posting procedures (posting collections on weekends versus business days only) and the number of days in the month. Banks that do not post collections on weekends typically pose more yield volatility.
- The length of the **grace period** can also influence the amount of interest consumers pay when they use credit cards to generate revolving credit.

NONINTEREST INCOME

Noninterest income includes, but is not limited to, interchange, annual fees and other periodic fees. Interchange represents the fee extracted from the merchant **discount rate** by the accepting entity and paid to the issuer. It is set by the Associations and normally is expressed as a certain percentage of the consumer's transaction plus a per-transaction fee ($). An annual fee is charged to the cardholder each year for use of the card and is typically assessed based on the perceived value of the credit card and any associated enhancements. According to Call Report instructions, fees that are periodically assessed are to be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card.

Certain income streams related to securitization activities also fold into noninterest income. The bank might report net servicing fees from servicing credit cards held by others (such as those that might be securitized). It might also report securitization-related earnings in the form of income streams associated with administrative support, liquidity support, **credit enhancement** support, or other support functions provided in an agent capacity. Additional impacts on earnings from credit card securitizations are discussed later in this section, and a full discussion of credit card securitization activities is housed in the Risk Management Credit Card Securitization Manual.

Noninterest income also includes charges to merchants for the bank's handling of credit card sales when the bank does not carry the related loan accounts on its books. Examiners should refer to the Merchant Processing chapter when reviewing merchant and acquiring programs.

INTEREST EXPENSE

The cost of funds is normally a major interest expense item and includes costs for items such as borrowings and brokered deposits. Funding costs vary depending on the parent's financial strength; the bank's size, condition, and reputation; and availability to the market. The UBPR details cost data for funding sources.

NONINTEREST EXPENSE

Noninterest expense includes, but is not limited to:

- Credit card processing costs.
- Marketing expenses.
- Collection costs.
- Credit card servicing costs.
- Fraud investigation costs and charge-offs
- Outsourcing costs.
- Litigation costs.

Noninterest expenses vary significantly, and the variations are normally related to the type of product offered, marketing techniques, collection procedures, technology employed by the processing department, and account or transaction volume. Direct mail solicitations remain a primary marketing channel and can result in a sizable amount of postage and mailing expenses. Printing expenses can be sizable due to the high volume of accounts. Overhead expenses tend to be higher in credit card operations than in other areas of a bank. The small size of individual accounts, the high transactional volume, and the myriad of servicing needs create higher costs per account. Because in-house data processing and collection costs are expensive, many banks contract these activities to third-party vendors.

FAS 91

Issuers often charge fees in connection with issuing or renewing a credit card and also incur certain credit card origination costs. Accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing loans are set forth in FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. The statement provides guidance on when and how loan origination and commitment fees and origination costs should be recognized in earnings. It applies to all types of loans, including credit card loans, and to all types of lenders. While a synopsis of the statement is offered here, examiners should refer to the pronouncement for full guidance and should look to accounting specialists when necessary.

FAS 91 is usually applied to individual loan contracts but aggregation of similar loans for purposes of recognizing net fees or costs and purchase premiums or discounts is permitted under certain circumstances as specified in the statement or if the result does not differ materially from the amount that would have been recognized on a loan-by-loan basis.

In general, FAS 91 specifies that:

- Origination fees should be recognized over the life of the loan as an adjustment of yield.
- Certain direct origination costs should be recognized over the life of the loan as a reduction of the yield.
- Most loan commitment fees should be deferred, except for specified exceptions.
- Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans are recognized as an adjustment of yield, generally by the interest method based on the contractual term of the loan.

With respect to credit cards, FAS 91 treats available lines of credit under credit card arrangements as loan commitments and views credit card fees as being loan commitment fees. However, it recognizes that credit card fees generally cover many services to cardholders. Therefore, FAS 91 requires fees that are periodically charged to cardholders to be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder to use the card.

The FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases: Questions and Answers*, discusses certain facets of the statement. Its answers for questions 31, 32, and 56 relate to credit card lending. Question 31 discusses the period and method that should be used to amortize costs associated with credit card originations. Question 32 talks about solicitation efforts that involve a third party. Question 56 discusses the amortization period if borrowings are repaid and the revolver is unused for a period of time. Examiners should refer to the implementation guide, which can be accessed through the accounting section of the FDIC's internal website, for details. They may also reference FASB Emerging Issues Task Force (EITF) Issue No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*, and EITF Issue No. 93-1, *Accounting for Individual Credit Card Acquisitions*. EITF Issue No. 88-20, *Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio* addresses the amortization of a premium paid when an entity buys a credit card portfolio. The Purchased Portfolios and Relationships chapter discusses portfolio purchases.

COMPETITION

Banks sometimes compete with one another for market share by offering low introductory rates and **convenience checks**. Teaser rates affect the offering bank by stimulating asset growth. Profitability is sacrificed on a per asset basis but, more dollars of overall net operating income are earned. As a result, ROA may tighten, but ROE normally increases by additional dollars earned, assuming no other changes to equity capital. Banks holding accounts on which balances are transferred to other banks via use of convenience checks may realize lower revolving balances or increased attrition.

The Associations periodically provide banks with cost studies and industry data which can be helpful in evaluating the bank's performance within the industry. The FFIEC's website contains a link to a customized UBPR for CCSBs, and the bank's UBPR may also reflect data from one of the three peer CCSB subgroups (as discussed in the CCSB section of the Identification of Involvement in Credit Card Activities chapter). All of these types of reports can be valuable tools for assessing profitability, but failure to consider differences such as products offered and risk appetites can invalidate the review's results.

GROWTH ENVIRONMENT

Earnings performance can be difficult to judge in a high-growth environment due to the uneven stream of cash flows. Loss rates do not stabilize until several months after origination. Further, the timing of costs is often not consistent with revenues. After the initial acquisition cost there is a period of revenues with minimal credit losses, and, later, a period of increasing credit losses.

MANAGEMENT REPORTING, BUDGETING, AND STRATEGIC PLANNING

Examiners should assess whether management has established adequate MIS that detail income and expense items and provide an accurate representation of profitability. They should consider whether reports are flexible while allowing management to make appropriate and effective future strategic decisions. In general, reports normally consider:

- The portions of the portfolio that have fixed- and variable-rate pricing.
- The re-pricing frequency on variable-rate products.
- Significant segments, and which of those segments contribute positively or negatively to profitability.
- Trends of income and expense items.
- The effects recent trends have on current earnings and may have on future earnings.

Furthermore, for banks to remain competitive, it is increasingly necessary for management to be able to measure and monitor profit levels at the individual-account level and possibly for each campaign. For example, an individual-account level understanding can be especially critical in establishing effective retention practices. Monitoring costs and profitability of each campaign can identify its success or failure, thus allowing management to respond accordingly.

The profit analysis portion of the examination normally incorporates the review of the bank's strategic plan as well as its budgets. Strategic plans vary between banks based on risk tolerance, growth objectives, and funding strategies. A failure of the bank's strategic plans and budgets to be based on realistic objectives and attainability given the market environment could result in substantial differences, potentially adverse, between plans and actual results. If budgets vary significantly from actual results or the strategic plan, or if the strategic plan contains material changes from past practices, examiners should discuss the causes or reasons for the variations with management.

CAPITAL SUPPORT

The evaluation of earnings should also consider the ability of earnings to appropriately support capital. The bank's flexibility to reduce dividend payments should be considered when analyzing the impact of dividends upon earnings. High earnings retention may or may not be necessary, depending on the situation. If growth is low, profits high, and capital strong, a relatively high dividend payout may be acceptable. But, if growth is rapid, profits are low, and capital is weak, any high dividend payout might be standing in the way of retaining needed capital.

QUALITY OF EARNINGS

Earnings quality is defined as the ability to continue to realize (or sustain) favorable earnings performance and is often closely linked to asset quality. A bank might register impressive profitability ratios and high volumes of income by assuming an unacceptable degree of risk. Short-term earnings might be boosted by seeking higher rates for the higher credit risk but ultimately, earnings might suffer if losses in these higher-risk assets are recognized. Poor portfolio quality could necessitate increasing provisions for loan losses as well as result in elevated account servicing costs and reduced fee income. Consequently, portfolio quality must be considered when determining earnings quality. And, similar to analysis at traditional commercial banks, examiners should be alert for short-term earnings performance that is enhanced by extraordinary items and/or tax strategies.

KEY FINANCIAL INDICES CONCERNING PROFITABILITY

The following indices are helpful in gauging earnings performance, including that of credit card operations:

- *Yield on Total Loans and Leases* – This ratio measures the amount of interest and fees on loans as a percentage of average total loans. The UBPR also contains a line item specific to yield on the credit card portfolio, which is especially helpful when the bank's loan portfolio contains a notable volume of other types of credits.
- *Net Losses to Average Total Loans* – This ratio measures the amount of gross charge-offs, less gross recoveries, as a percentage of average total loans. The UBPR also contains a line item specific to losses attributed to credit card plans. This line item is again particularly helpful when the bank's loan portfolio contains a notable volume of other types of credit.
- *Percentage of Variable-Rate Loans to Total Loans, and Percentage of Fixed-Rate Loans to Total* Loans – These ratios measure the percentages of variable-rate and fixed-rate loans and are useful in assessing the bank's sensitivity to market risk.
- *Operating Expenses to Active Accounts* – This ratio measures the percentage of operating expenses used to maintain an active account relationship.

The usage ratio and the payment rate are also helpful and are discussed in the Liquidity chapter.

CONSIDERATION OF SECURITIZATIONS AND CARD-ISSUING RENT-A-BINS

In credit card securitizations, credit card receivables are taken off the bank's balance sheet while a residual income stream generated from the receivables continues to flow to the bank. The earnings performance of the portfolio will be overstated if the profitability analysis only considers on-book receivables but all credit card related income streams. Securitization changes the bank's income composition such that the result is less interest income and more fee-based income. For example, if a bank retains servicing, it receives servicing fees. However, in that case, personnel expenses will likely be high relative to the bank's on-book asset volume.

Securitization does not change the true operating performance of the credit card portfolio. When a bank is involved with securitizations, examiners should determine whether management considers **total assets under management** in its profitability analyses. Supplemental earnings indices used to incorporate consideration of securitization activities may include:

- *Return on* ***Estimated Managed Assets*** – This ratio measures the return on assets by adding all receivables securitized to the average assets and represents overall profitability on a managed basis.
- *Average Cost of Securitization versus Average Balance Sheet Funding Cost* – This ratio measures the off-balance sheet funding cost in relation to the balance-sheet funding cost.
- *Excess Finance Charges to Estimated Average Securitized Assets* – This ratio measures the profitability of the bank's securitized receivables after all obligations of the **Qualified Special Purpose Entity** have been met in relation to estimated average managed assets.
- *Excess Finance Charges to Noninterest Income* – This ratio measures the amount of income from securitization activities in relation to total noninterest income.

Examiners should refer to the Risk Management Credit Card Securitization Manual for additional information on securitizations, including a discussion on excess finance charges.

Issuing Rent-a-BINs can create similar changes to the income statement. Since most or all of the receivables are usually not held by the bank, interest income on those balances usually does not go to the bank. However, a noninterest income stream flows to the bank via the fee paid from the partner to the bank. The bank might also earn servicing or other revenues, depending on the contracts. The Credit Card Issuing Rent-a-BINs chapter discusses income and cost statement expectations when a bank operates a Rent-a-BIN program. Situations in which management is not reviewing the financial performance of the card portfolio(s) as well as the financial statements of the partner warrant examiner attention as do situations in which management is not preparing and reviewing bank-only analyses for income received and costs incurred for operating the Rent-a-BIN program.

SUMMARY OF EXAMINATION GOALS - EARNINGS

Examiners assess the quantity, quality, and sustainability of earnings from credit card operations and consider the impact of those earnings on the quantity, quality, and sustainability of overall bank earnings. Tools available to assist the examiner include, but are not limited to, the UBPR, the Call Report (including its instructions and glossary), the bank's financial statements and subsidiary ledgers, and management's analytical reports. An effective analysis of earnings generally includes:

- Evaluating the quality and depth of management and staff of the finance department (or of the individuals designated to oversee earnings if there is not a finance department) based upon size and complexity of the issuer.
- Reviewing income and expense categories to evaluate which components contribute positively or negatively to the bank's operations.
- Determining the type and level of fee-based income received and reviewing trends.
- Considering the extent to which fees are a recurring and viable source of revenue.
- Verifying that the bank appropriately recognizes uncollectible accrued interest and fees through the ALLL or other appropriate allowance-type mechanisms.
- Determining how teaser rates and convenience checks play into the bank's marketing and promotional campaigns and what effect these practices have on earnings.
- Determining if management monitors the amount of convenience users in relation to revolvers and what effects convenience users are having on earnings.
- Determining if the bank's accounting system is capable of generating profit data by product, segment, channel, and account.
- Analyzing whether management adequately monitors and assesses profitability on the portfolio and each significant segment and identifying whether reports are useful and accurate.

- Reviewing the pricing matrix by product.
- Assessing the adequacy of a bank's processes for pricing products as well as projecting and tracking profitability of each product, including determining whether all costs associated with the loans are considered.
- Reviewing pricing models, if applicable.
- Reviewing major assumptions used in the pricing method and considering differences in assumptions by product and channel.
- Determining whether pricing is driven by risk, capital, or another allocation method or hurdle.
- Determining how much pricing is driven by competition.
- Determining whether the pricing method incorporates a realistic break-even analysis, and whether the analysis reflects the true costs of attrition and reductions (prepayment).
- Evaluating budgets, including deciding whether assumptions are reasonable and whether the budgets are consistent with strategic plans.
- Reviewing the most-recent fiscal year-end and current year-to-date financial information and comparing results to budgets and forecasts to determine significant variances.
- Determining the impact of any contingent liabilities from rebate reserves and any associated impact on earnings.
- Considering findings from the allowance adequacy assessment and whether additional provisions are necessary to adequately fund allowances.
- Determining, quantitatively, profitability on estimated average managed assets when the bank uses securitization.
- Reviewing accounting practices.