

VI. PURCHASED PORTFOLIOS AND RELATIONSHIPS

Intense competition in the credit card industry is often accompanied by high costs to originate new card accounts. As a result, some banks find it more profitable to purchase credit card portfolios. In addition, some banks buy card portfolios to utilize excess servicing capacity, swiftly grow receivable holdings, or diversify assets. Rapid receivable growth could stress the bank if it is not able to properly manage the additional volume of and/or risks of the receivables taken on. Excessive amounts paid for portfolios (as a result of overvaluation) could result in necessary write-downs, and changes in the purchased portfolio's cash flow drivers after acquisition could necessitate write-downs of intangible assets booked in connection with the purchases.

PORTFOLIO ACQUISITIONS

Examiners should expect that banks that purchase portfolios have strong, well-defined policies and practices regarding portfolio acquisitions. Each prospective portfolio must be properly assessed and valued. This normally includes thorough, well-documented due diligence processes by management as well as portfolio performance and profitability analyses. Management is expected to fully understand the credit risks that it would assume if it purchases the portfolio as well as understand the seller's operations to ensure that the bank will be able to reasonably integrate the prospective portfolio into its own operations. Examiners should look for evidence that each decision to purchase, including the purchase price, took into account the effect the purchased portfolio would have on the bank's overall risk profile. Failure by management to properly exercise its responsibilities could result in the bank purchasing portfolios that are of a lesser credit quality than it desires and consequently that it may be not able to control. Cardholder performance that is unfavorable compared to what was anticipated at the time of purchase could lead to increased servicing and collection costs as well as higher credit losses than planned. As a result, asset quality, earnings, liquidity, and ultimately capital could be adversely affected. Furthermore, an unplanned need to direct management's attention to increased oversight of the portfolio could have the potential to spread management's resources too thin and consequently adversely impact oversight of the bank's other activities.

If subprime loans have been purchased, examiners should confirm whether management followed the March 1, 1999 *Interagency Guidance on Subprime Lending*. According to that guidance, banks that purchase subprime loans must give due consideration to the cost of servicing the subprime assets and to the loan losses that may be experienced, which are typically much higher than those for prime portfolios. Some lenders who sell subprime loans charge borrowers high up-front fees that are frequently financed into the loan. As such and to the detriment of a potential purchaser, originators could be inclined to produce a high volume of loans with little emphasis on quality. Further, subprime loans, especially from outside the bank's typical lending area, could carry special risk for fraud or misrepresentation (that is, the quality of the loan may be less than loan documents indicate). Examiners should look for evidence that management performed a thorough due diligence review prior to committing to purchase subprime credit card loans and normally only accepts credit card loans that meet the bank's underwriting criteria.

Whether the purchased loans are prime or subprime, marked deterioration in their quality or performance compared to the quality or performance expected points to the need for a thorough reevaluation by management of the originators, as well as re-evaluation of the bank's criteria for assessing prospective loan purchases and selecting originators (sellers). It might also highlight a need to modify or terminate the relationship with the seller or make adjustments to underwriting and originator selection criteria.

A variety of factors impacts a portfolio's cash flows and, thus, can help determine its purchase price. In general, factors include the portfolio's yield, attrition rates, charge-off rates, funding rates, fee income, and processing costs. Most banks that purchase credit card portfolios maintain automated software models that management loads with portfolio performance estimates. Models typically generate a host of information that can help the purchaser determine whether it should purchase the portfolio and what an appropriate value for the portfolio would be.

PURCHASED CREDIT CARD RELATIONSHIPS

Examiners should verify that management carefully and thoroughly assesses intangible assets recognized in connection with the acquisition of card portfolios. These intangible assets are commonly known as purchased credit card relationships (PCCRs). PCCRs represent the right to conduct ongoing credit card business dealings with the cardholders and normally are recorded as assets when a bank purchases existing credit card receivables at a premium and has the right to provide card services to the cardholders whose credit card accounts have been purchased. PCCRs may also be acquired when a bank purchases an entity that owns a credit card portfolio.

Banks can continue to reflect PCCRs for purchased portfolios that are securitized. This conclusion is based on the continuation of account ownership by the bank and the inherent value in the cardholder relationship.

ACCOUNTING

All assets acquired and liabilities incurred in a portfolio purchase are normally recognized and measured at fair value. When quoted market prices are not available, fair value is estimated based on the best information available in the circumstances. The fair value methodology considers prices for similar assets and liabilities and the results of valuation techniques to the extent available. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. In addition to being consistent with the objective of measuring fair value, techniques should be designed to incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, defaults, payments, and volatility. When used to estimate fair value, estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections and should consider all available evidence.

The premium (difference between the amount paid and the sum of balances of the credit card loans purchased) should be allocated between the cardholder relationships acquired (that is, the PCCRs) and the loans acquired. The premium allocated to the loans acquired should be amortized over the life of the loans in accordance with FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. After this initial allocation, the PCCRs are carried at amortized cost.

In July 2001, FAS 141, *Business Combinations*, and FAS 142, *Goodwill and Other Intangible Assets*, were issued. FAS 141 requires that intangible assets acquired in a business combination be recognized as assets apart from goodwill if they meet one of two criteria: the contractual-legal criterion or the separability criterion. If an entity establishes relationships with its customers through contracts, such as cardholder agreements, those customer relationships would arise from contractual rights. Thus, customer contracts and the related customer relationships are intangible assets that meet the contractual-legal criterion. The amount to be assigned to PCCRs at acquisition in a business combination is the estimated fair value. FAS 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon acquisition. Upon acquisition, these intangible assets are to be initially recognized and measured based on fair value.

Subsequent to acquisition, PCCRs acquired in a business combination individually, or with a group of other assets, are to be accounted for in accordance with FAS 142. This is because the nature of an asset, not the manner of its acquisition, determines subsequent accounting for the asset. According to FAS 142, those intangible assets that are not deemed to have an indefinite life (rather, they have a finite life), such as PCCRs, are to be amortized over their useful lives.

The estimate of the useful life of an intangible asset is to be based on an analysis of all pertinent factors such as the entity's expected use of the asset and any legal, regulatory, or contractual provisions limiting its useful life. Examiners should verify that PCCRs are being amortized using a method that reflects the pattern in which the economic benefits of the intangible assets are consumed. For PCCRs, these benefits are consumed as the revenue stream generated by the cardholder relationships is realized. Because the revenue stream normally declines each year after purchase, use of an accelerated method of amortization based on the estimated attrition rate of the purchased credit card accounts generally results. If a usage pattern cannot be reliably determined, which is unlikely to be the case for PCCRs, the straight-line method must be used. The estimated useful life of PCCRs most often does not exceed 10 years. However, in rare cases, a longer useful life and amortization period may be justified. Cases where support for the estimated useful life applied is not adequate or well-documented generally cause concern.

Examiners should look for evidence that management performs a quarterly evaluation of the PCCRs, including documentation thereof, and adjusts the carrying value as necessary. They should determine whether management properly considers unanticipated acceleration or deceleration of cardholder payments, account attrition, changes in fees or finance charges, or other events or changes in conditions that may point to the carrying amount of the PCCRs not being recoverable. If the carrying amount might not be recoverable, examiners should verify that management tests the PCCRs for recoverability and, if not recoverable, recognizes any impairment loss in accordance with FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The carrying amount is not recoverable if it exceeds the sum of the undiscounted expected future cash flows from the intangible asset. The PCCRs would then be written down to their fair value (e.g., the present value of estimated future cash flows from the intangible asset).

As of October 1, 2002, FAS 144 applies to long-term customer-relationship intangible assets such as PCCRs that are recognized in the acquisition of a financial institution (as set forth in paragraph 6 of FAS 147, *Acquisitions of Certain Financial Institutions*). According to FAS 147, those intangibles, which include those acquired in transactions between two or more mutual enterprises, are subject to the same undiscounted cash flow recoverability test and impairment loss recognition and measurement provisions that FAS 144 requires for other long-lived assets that are held and used.

Examination of PCCRs normally requires the examiner to review management's original acquisition model, the quarterly cash flow and fair value models, and related data that support management's assumptions. The supporting documentation is the basis which determines the proper amount of PCCRs that should be included in regulatory capital.

CAPITAL LIMITATIONS FOR PCCRs

PCCRs are one of only a few intangible assets that are not deducted from Tier 1 capital, subject to certain limitations. A deduction of all or a part of the PCCRs may be required if the carrying amount is excessive in relation to their market value or the level of the bank's capital accounts. Consequently, PCCRs will be recognized for regulatory capital purposes only to the extent they meet the conditions, limitations, and restrictions described in Section 325.5(f) of the FDIC's Rules and Regulations. Examiners should refer to Part 325 – Capital Maintenance for details. In summary, for purposes of determining Tier 1 capital, PCCRs will be deducted from assets and from equity capital to the extent that they do not meet the following conditions, limitations, and restrictions: valuation requirements; fair value limitation; Tier 1 capital limitation; and Tier 1 capital sub-limit, each of which is discussed on the next page.

Valuation Requirements

The fair value must be estimated at least quarterly and shall include any adjustments for any significant changes in the original valuation assumptions, including changes in payment estimates or attrition rates. The FDIC has the discretion to require independent fair value estimates on a case-by-case basis when deemed appropriate for safety and soundness reasons.

Fair Value Limitation

For calculating Tier 1 capital, but not for financial statement purposes, mortgage servicing assets (MSAs), PCCRs, and non-mortgage servicing assets (NMSAs) are each to be reduced to an amount equal to the lesser of:

- 90 percent of the fair value of these assets; or
- 100 percent of the remaining unamortized book value of these assets (net of any valuation allowances), as determined according to Call Report instructions.

Tier 1 Capital Limitation

The maximum allowable amount of MSAs, PCCRs, and NMSAs in the aggregate is the lesser of:

- 100 percent of the amount of Tier 1 capital that exists before deduction of any non-financial equity investments or any disallowed:
 - MSAs.
 - PCCRs.
 - NMSAs.
 - Credit-enhancing IO strips.
 - Deferred tax assets; or
- The sum of the amounts of MSAs, PCCRs, and NMSAs determined in accordance with the fair value limitations.

Tier 1 Capital Sub-limit

In addition to the aggregate limit placed on MSAs, PCCRs, and NMSAs as described in the Tier 1 Capital Limitation section, a sub-limit applies to PCCRs and NMSAs in the aggregate. The maximum allowable amount is limited to the lesser of:

- 25 percent of the amount of Tier 1 Capital that exists before the deduction of any non-financial equity investments or any disallowed:
 - MSAs.
 - PCCRs.
 - NMSAs.
 - Credit-enhancing IO strips.
 - Deferred tax assets; or
- The sum of PCCRs and NMSAs determined as described in the Fair Value Limitation section.

LOAN LOSS ALLOWANCES FOR PURCHASED PORTFOLIOS

Under current accounting practices, banks typically book an increase in their loan loss allowance as part of their entries to record the purchase of a credit card portfolio. This increase in the allowance occurs without the recording of an income statement entry for a loan loss provision. In some cases, this has resulted in the credit card receivables being recorded at a premium, which must be amortized as an adjustment to the yield of the purchased portfolio over the life of the

loans in accordance with FAS 91.

In general, when a bank purchases a credit card portfolio, including a portfolio acquired in a business combination, the portion of the allowance for loan and lease losses (ALLL) on the seller's balance sheet that relates directly to, or has been allocated to, the purchased portfolio is carried over and recorded as an increase in the purchaser's ALLL at the time of acquisition. However, as discussed below, if any of the acquired credit card receivables fall within the scope of AICPA Statement of Position 03-03, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3), an adjustment must be made to the portion of the seller's ALLL that is carried over to the purchaser's books. Other adjustments to the portion of the seller's ALLL that the purchaser carries over generally are not appropriate, except in the limited circumstances discussed in the Securities and Exchange Commission's (SEC) Staff Accounting Bulletin No. 61, *Adjustments to Allowances for Loan Losses in Connection with Business Combinations* (Codified in Topic 2.A.5 in the SEC's Codification of Staff Accounting Bulletins). Under all circumstances, management should provide adequate documentation to support the amount of the allowance that is carried over as an increase in the purchasing bank's ALLL and a means by which it can be verified objectively.

SOP 03-3 prohibits a bank from carrying over or creating loan loss allowances in the initial accounting for purchased **impaired** loans (i.e., loans that a bank has purchased where there is evidence of deterioration of credit quality since the origination of the loan and it is probable, at the purchase date, that the bank will be unable to collect all contractually required payments receivable). This prohibition applies to the purchase of an individual impaired loan, a pool or group of impaired loans, and impaired loans acquired in a purchase business combination.

With respect to credit card receivables, SOP 03-3 provides that accounts of cardholders who have "revolving privileges," i.e., can continue to use the credit card for purchases and cash advances, are not to be treated as purchased impaired loans. Although the credit card receivables of cardholders whose revolving privileges have been revoked must be individually evaluated to determine whether they meet the criteria for being treated as a purchased impaired loan under SOP 03-3, such receivables will normally meet these criteria. The bank that purchases these impaired credit card receivables must determine the amount of the seller's ALLL allocated to the entire purchased portfolio that should be attributed to the impaired receivables because this amount may not be carried over to the purchaser's ALLL. If the seller had not specifically attributed a portion of its ALLL to the credit card receivables for which the cardholders' revolving privileges had been revoked, the purchaser should consider the fact that such receivables likely have additional risk characteristics compared to the credit card accounts that have revolving privileges. As a consequence, within the seller's ALLL allocated to the entire purchased portfolio, the amount attributable to the receivables of cardholders whose revolving privileges had been revoked would be expected to be a larger percentage of the seller's ALLL than simply the percentage of purchased impaired receivables in the purchased portfolio. Thus, management should maintain adequate documentation to support its determination of the estimated amount of the seller's allowance attributable to purchased impaired credit card receivables that cannot be carried over under SOP 03-3.

Subsequent to the acquisition of purchased impaired credit card receivables accounted for in accordance with SOP 03-3, the purchaser must continue to evaluate the cash flows expected to be collected on these receivables. If, upon such a subsequent evaluation, management determines, based on current information and events, that it is probable that the bank will be unable to collect all cash flows expected at acquisition (plus additional cash flows expected to be collected arising from changes in estimate after acquisition) on a purchased impaired credit card receivable, the receivable should be considered impaired for purposes of establishing an allowance pursuant to FAS 5 or 114, as appropriate.

Loan loss allowances for credit card portfolios are discussed in the Allowances for Loan Losses chapter.

SUMMARY OF EXAMINATION GOALS – PURCHASED PORTFOLIOS AND RELATIONSHIPS

The examiner's role generally includes the following activities:

- Determining whether the bank has purchased any credit card portfolios.
- Determining if the bank has booked any PCCRs.
- Assessing the bank's policies governing portfolio purchases and PCCRs, including any accounting policies.
- Reviewing the original acquisition model.
- Evaluating management's most recent quarterly fair value estimate to determine the eligible amount of PCCRs for regulatory capital. Also, deciding the following:
 - Whether the discount rate used in the determination of fair value is appropriate.
 - Whether the time period used in the cash flow models and the amortization period and methods are appropriate for the PCCRs associated with each segment in the purchased portfolio.
- Reviewing the amount of any ALLL carried over in connection with the purchase of a credit card portfolio to determine that it does not exceed the amount allocated to the sold portion of the portfolio on the seller's balance sheet, adjusted for the amount of the seller's ALLL attributable to purchased impaired credit card receivables.

Examiners should consult with accounting specialists as necessary.