Best Practices for Credit Card Operations

A. Organisation Structure

- There should be sufficient segregation of duties in the following functions to ensure that there are adequate checks and balances in the credit card operation:

  - Marketing and account solicitation (see section C below)
  - Application approval (see sections D and I below)
  - Credit risk management (see section E and F below)
  - Fraud control (see section G below)
  - Delinquency management (see section H below)

B. Policies and Procedures

- The policies and procedures for credit card operations should cover the following areas-

  - Application approval: These should describe clearly the minimum criteria for approving new cards, the mechanism for review of these criteria, the frequency of such review, the documentation requirements, the policy relating to setting of credit limits for credit card holders and the authority for approving exceptions.
  - Credit risk management: These should set out the procedures for credit line management such as credit line increase, and the criteria for card upgrade and renewal. The role and functions of the credit risk management unit should be clearly described, including how the credit quality of the portfolio should be evaluated regularly, and how corrective actions should be taken in order to maintain the portfolio at an acceptable level of risk to the authorized institution ("AI").
  - Delinquency management: These should cover the classification of delinquent accounts, provisioning, charge-off, and collection actions.

C. Marketing and Account Solicitation

Marketing programme

- A well-documented proposal should be prepared for each marketing programme. The proposal should describe, among other things,

  - the target market segment and forecasted customer response rate,
  - the profit projection and expected delinquency rate,
  - the approval criteria and documentation requirements,
  - the policy on credit limit assignment, and
  - the requirements for operational and system support.

- There should be procedures to require all marketing proposals to be reviewed and endorsed by other relevant departments of the AI, before implementation, to ensure that the proposals are financially and operationally sound. The departments that should be involved include:

- financial control to ensure that the profit projection is reasonable,
- credit risk management to ensure that the underwriting criteria are prudent and appropriate risk control measures are in place,
- legal and compliance to ensure that the proposal complies with the relevant regulatory requirements and the AI's internal policies and limits, and
- operational support to ensure that adequate system capacity is available to support implementation of the proposal.

Post-programme evaluation

- A post-programme evaluation should be conducted for each marketing programme to ascertain whether the parameters used for the marketing proposal were reasonable. The results of the evaluation should be reviewed by credit risk management and taken into account in the planning and implementation of future programmes.

Pre-approved, affinity or co-branded card programmes

- AIs often use "pre-approved" or "affinity or co-branded card" programmes to solicit a target group of customers. This is acceptable as long as the offer of such programmes does not amount to automatic granting of a credit card to the selected customers. Under prudent approval procedures, customers should still be required to submit an application form and assessed against prudent underwriting criteria. An application should be rejected if it fails to meet the minimum approval criteria.

Account solicitation

- AIs should seek information about the present credit commitments of applicants on the application form. This should include information on the number of other credit cards held by the applicant and the approximate amount of total outstanding credit balance on these cards. Solicitation of such information would facilitate prosecution of fraud cases if the applicant subsequently defaulted and had made a false statement.

D. Approval Process

Underwriting criteria

- Procedures should be in place to screen out applicants with unfavourable credit attributes. This is usually achieved by requiring the applicant to meet a set of underwriting/approval criteria before approving the application. Such criteria should include, among others, -

  - income level,
  - employment and length of service (AIs should have procedures to identify occupations that carry higher credit risks),
  - acceptable credit record,
  - asset requirement (especially for high-risk customers or customers with no stable income source),

- acceptable age range,
- residence type,
- permanent residence (e.g. Hong Kong or Macau).

- Where a credit-scoring model is used to screen applications, the AI should ensure that the credit-scoring system is regularly reviewed, and if necessary, updated to ensure that it remains valid despite changes in customer profile (see section I below).

Documentation and verification

- Front-line staff should check the application for documentation completeness and screen out unqualified applications, e.g. under age.

- Valid documents for verification of customer profile should be obtained. These should include satisfactory evidence of:

  - identity proof (e.g. copy of Identity Card or passport),
  - residential address proof,
  - income proof/asset proof (the credit policy should define the types of acceptable valid income/asset proof),
  - for student cards, information about the parents' employment should be obtained.

- AIs sometimes waive the requirement for income proof and accept evidence of home ownership, recent credit card statements issued by another card issuer, or club membership, as alternative means ("income surrogates") to estimate the income of the applicant. In general, this should not be a standard practice and should not be used as a selling point in promoting credit card products. Income surrogates are acceptable only if they provide reliable data to enable the AI to accurately estimate the income level of the applicant. Certain income surrogates, such as credit card sales slips or subscription to mobile phone services, may not be reliable substitutes for the purpose of estimating an applicant's income. Where income surrogates are used, AIs should consider granting a lower credit limit to cater for the additional risk.

Credit checking

- Checking of the applicant against internal records and with an external credit reference agency should be performed for new customers, renewal of facilities and increase in credit limits.

- AIs should also check with a credit reference agency whether an applicant has lodged a petition for bankruptcy in order to avoid extending further credit to him.

Special accounts

- Guidelines should be established for handling applications from customers who do not have a stable income source e.g. students, housewives and self-employed individuals. In particular, such guidelines should set out clearly how the repayment ability of these customers should be assessed and the credit limit should be set.

Process control

- There should be guidelines for handling approval of exceptional cases (e.g. where documentation is incomplete or the applicant is found to have negative credit history).
- There should be a cap on the number of exceptional approvals.
- For AIs using a credit scoring system, there should be a cap on the number of cases referred for manual review. If the cap is exceeded, the underlying reasons should be investigated.
- Guidelines for adopting income surrogates as substitutes for income proof should be established.

Control of credit limit assignment

- Credit limits (including increase in existing credit limits) should be decided on the basis of the credit profile of individual customers and by reference to the applicant's monthly income. For AIs using a credit scoring system, credit limits should be assigned by reference to the credit score attained.
- When deciding on the credit limit for a customer, AIs should have regard to the applicant's other credit commitments as revealed in the credit checking process. For risk control purpose, a maximum unsecured credit limit should be set for each customer with sub-limits for each credit card product.

E. Credit Risk Management – Account Management

Account management process

- The account management system should be able to segment customers into different risk types (e.g. high, medium or low). Risk grading should be assigned to each customer on a regular basis according to his/her account behaviour such as credit line utilisation, frequency of cash advance, payment of minimum balance, timeliness of repayment, and delinquency record.
- Decisions such as increase in credit limit and card renewal should be based on the customer's credit risk profile.
- For customers in the high-risk category, there should be an effective mechanism to reduce the maximum credit limit granted in a timely manner, freeze the remaining available credit line, or block the customer's credit card from further transactions, as appropriate.

F. Credit Risk Management – Portfolio Management

Management oversight

- The credit risk management unit should regularly provide sufficient information on the asset quality of the credit card portfolio for management review. This

would help management to identify the level of risk and initiate prompt corrective actions if necessary.

Portfolio management

- The credit risk management unit should regularly review and monitor the quality of the portfolio by segmenting the portfolio (e.g. by marketing programme, delivery channels and time-on-book) and evaluating both historical and forecasted trends in profitability, delinquencies, and charge-off ratios.
- Adequate MIS reports should be made available to the credit risk management unit for portfolio management purpose. Regular performance tracking reports should be generated for review covering the following:
  - revenue and profitability;
  - delinquency analysis;
  - provisioning and charge-off; and
  - credit line utilisation

- Stress testing of the portfolio under various scenarios (e.g. increase in charge-off ratios, rise in unemployment or changes in interest margins) should be regularly conducted.

- The portfolio should be analysed to identify high risk groups of cardholders and the AI's exposure to them.

- Yardsticks signalling further deterioration of portfolio quality and the need for corrective actions should be established and documented.

Preventive / Corrective actions

- Policies and procedures should be established on prompt corrective action to deal with deterioration in asset quality. Such action should, in general, include adjusting the approval scores, tightening the initial credit line assignment, tightening credit line increase, increasing collection capacity and making early reminder calls on overdue accounts.

G. Fraud control

- Management should have appropriate systems and controls in place to ensure that fraudulent activities are recognised in a timely manner and the affected accounts are appropriately blocked to prevent further transactions being conducted through these accounts. AIs should ensure that proper training is conducted for employees regarding fraud systems and controls, and fraud recognition and handling. Accurate and timely MIS reporting on fraud is critical in controlling fraud losses.

- AIs should review their average fraud losses to determine if staff are identifying fraud activities in a timely manner. If an AI has inadequate systems and controls to identify fraud, this will likely result in frauds running longer, permitting more transactions, and eventually higher losses.

- AIs should maintain a dedicated fraud unit to manage the various activities required when a cardholder notifies the AI or the AI becomes aware of a fraud. Such activities include preparing fraud reports, notifying relevant card holders (where appropriate), blocking the relevant account from further transactions, investigation on fraud accounts, preparing fraud notifications to Visa/MasterCard, and reporting the fraud to the relevant authorities for investigation and prosecution.

H. Delinquency Management

- An independent collection unit should be set up for managing delinquent accounts and collection actions.

- There should be effective policies on delinquency management covering the classification of problem accounts, provisioning, charge-off, controls on re-aging accounts[1], and collection actions.

- There should be adequate MIS reports to support delinquency management. Regular tracking reports on the effectiveness of collection actions should be reviewed by the collection unit.

- Guidelines and procedures should be established for the appointment of external debt collection agencies for debt recovery and adequate controls should be in place to ensure that the management of such agencies is in line with the provisions in the Code of Banking Practice.

- AIs should report suspicious cases of fraudulent bankruptcies to the relevant authorities for investigation. These should include cases where customers obtained or attempted to obtain credit after filing of petitions for bankruptcy.

I. Scoring System

- Scoring systems/scorecards are tools used to predict the credit behaviour of individual customers based on historical data. They evaluate the credit quality of a borrower by assigning scores (developed by statistical methods) to defined credit attributes. Usually, vendors build scorecards based upon specific information and parameters provided by bank management. There are generally 2 types of scorecards, credit scorecards and behaviour scorecards. Credit scorecards are used in new account application to assess the creditworthiness of new applicants. Behaviour scorecards assess the quality of a customer through studying his account performance and credit behaviour such as cash advance, payment behaviour and credit line usage over time. Behaviour scorecards are usually applied in individual account management, collection or fraud detection.

- There should be a proper management approval process for the rollout of new scorecards. Such process should include selection of data samples, testing of the model, and approval hierarchy for the rollout.

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[1] Re-aging is the practice of bringing a delinquent account current after the borrower has demonstrated a renewed willingness and ability to repay the loan by making some, but not all, past-due payments.

- Scorecards should be developed by credit risk management and, if necessary, in conjunction with an external vendor with relevant expertise in statistical modelling. Scorecards should be validated by appropriate testing on bad rate (i.e. percentage of approved accounts that became delinquent), profitability modelling, as well as user acceptance before formal implementation.

- For application scoring models, the cut-off score should reflect the underwriting standards and risk appetite of the AI. There should be proper controls on who may decide and approve the level of the cut-off score, and the circumstances under which the cut-off score may be revised. Reasons and justifications for the setting or changing of the cut-off scores should be properly documented.

- To achieve better predictability of the scoring model, the development samples should be selected from the AI's existing customer database with a reasonably long account history of, say, 2 years.

- Credit risk management should regularly monitor the performance of the scorecard by reviewing management reports covering:

  - population stability[2],
  - characteristic analysis[3],
  - approval rate and rejection rate,
  - high and low side override rate[4],
  - delinquency vintage analysis[5].

- Proper controls for initiating the redevelopment of scorecards should be established specifying the criteria for initiating the redevelopment, and who may initiate and approve the redevelopment. Potential signals for redevelopment of the scorecards, include

  - significant shift of population from the development sample,
  - continuous high override rate,
  - continuous high delinquent rate.

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[2] Population stability reports compare the current application population and the population on which the scoring system was developed and measure whether there are any material changes in the score distribution over time.

[3] "Characteristic Analysis" measures changes in applicants' scores on individual credit attributes over time. It is needed when the population stability has changed and the bank wants to determine which credit attributes are causing the change.

[4] An override is a decision to accept or reject an applicant when the scoring system says otherwise. A high-side override means the AI rejects an applicant which the score system would approve. A low-side override means that the AI approves an applicant which the score system would reject.

[5] Delinquency vintage analysis refers to analysis of the distribution of the delinquency ageing by time of account inception.