Statement of the Office of the Comptroller of the Currency

Provided to the Subcommittee on Financial Institutions and Consumer Protection

Senate Committee on Banking, Housing, and Urban Affairs

"Shining a Light on the Consumer Debt Industry"

July 17, 2013

Introduction

Chairman Brown and Ranking Member Toomey, please find below a statement for the Subcommittee hearing record regarding the Office of the Comptroller of the Currency's (OCC) supervision of debt collection and debt sales practices of national banks and federal savings associations (collectively, banks). Lending is a central part of the business of banking. It is the means by which banks and savings associations meet the credit needs of the customers and communities they serve. With lending comes the risk of some of that debt going unpaid. While banks have a responsibility to their shareholders to minimize and recover losses on their unpaid debts, they must do so in a safe and sound manner that complies with applicable laws and consumer protections.

Since the beginning of his term, Comptroller Curry has stressed the importance of banks effectively managing the operational risks associated with their activities. Debt collection and the sale of charged-off debt raises operational and reputational risks that the agency expects institutions to manage effectively and in a manner that ensures customers are treated fairly.

The process of debt collection actually begins with the issuance of the loan. When current, that debt is collected through the routine payment and servicing of the loan. When delinquent, collection involves additional efforts that can involve internal collections by the bank, collection on behalf of the bank by a third party (referred to as debt placement), or the sale of the debt to a third party debt collector, where the bank no longer retains a legal interest in the debt. Improving debt collection practices and establishing effective controls reduce risks facing banks but also provide important consumer protections by ensuring debt collectors (banks or third parties) seek the right amounts of repayment from the right borrowers in the appropriate manner. This statement provides an overview of the OCC's supervision of consumer debt collection and debt sales activities of banks. It provides a brief description of the scope of debt collection and debt sales activity within the federal banking system, a description of ongoing supervisory concerns and actions, and a discussion of policy implications.

Scope of Debt Collection and Debt Sales Activity Within the Federal Banking System

As providers of consumer credit, banks are in the business of lending money to be repaid with interest. They underwrite the loans and price them according to the risk associated with that lending and the customers' creditworthiness. A certain percentage of the loans that banks make go unpaid. Under the Interagency Uniform Retail Classification and Account Management Policy guidelines, banks must charge off open-ended retail credit loans, such as credit cards, once they have become 180 days past due.[1] When a bank charges off a debt, it realizes a loss, but the borrower generally continues to have an obligation to repay the loan. At that point, the bank faces a business decision on how to recover that loss or not to pursue collection of the debt. Debt collection may take several forms, including continued efforts by the bank to collect it on its own, the hiring of a third party to collect the debt on its behalf, or the sale of the debt to an unaffiliated third party, which generates a partial recovery. While banks are expressly

[1] See OCC Bulletin 2000-20, "Uniform Retail Credit Classification and Account Management Policy." http://www.occ.gov/news-issuances/bulletins/2000/bulletin-2000-20.html.

authorized to conduct debt collection activities,[2] that decision must involve a consideration of all of the legal, reputational, and operational risks associated with the debt and the collection activity. The remainder of this statement focuses on one aspect of banks' debt collection activities, debt sales.

The majority of bank debt sales activity is concentrated among the 19 largest banking organizations, with the five largest making up about 82 percent of the annual total average sales of debt. On average, the 19 largest banking organizations have sold about $37 billion in charged-off debt sales in each of the past few years.

To provide some context to this number, the total retail credit portfolio for these 19 banks averaged $2.5 trillion each of the last five years. During that period, their combined annual charge-offs on these portfolios averaged $93.2 billion. The amount of retail debt charged off in recent years has fallen significantly as the economy has improved, with charge-offs declining from $130 billion in 2010 to $67.8 billion in 2012, a decline of more than 48 percent.

The vast majority of debt charged off by these large financial institutions and sold to third party debt collectors involves delinquent debt related to credit cards, but also includes other types of consumer credit such as auto, home equity, mortgage, and student loans.

The value of debt sold to third party debt collectors likewise varies significantly based on the age of the debt, the completeness and quality of records related to the debt, previous work done to collect the debt, and the amount of debt being sold overall (supply). Recently, charged-off debt has sold for between $.05 and $.10 for every dollar of most types of debt. That price has increased lately as the overall supply of debt sold has declined.

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[2] See *Activities Permissible for a National Bank, Cumulative*, http://www.occ.gov/publications/publications-by-type/other-publications-reports/bankact.pdf.

The volume of charged-off debt sold by the largest banks has decreased over the past few years. The drop reflects both the improvement in portfolio quality and a decision by some banks to limit or curtail their debt sales due to the heightened reputation and legal risks such activity can pose.[3]

Ongoing Supervisory Concerns and Actions

The OCC expects all national banks and federal savings associations to have policies and procedures in place to manage their debt collection activities effectively. This includes managing the operational and reputational risks, and complying with all relevant consumer protection laws. When banks sell debt, the agency expects them to have policies, procedures, and practices that result in the third party treating customers fairly and consistently with the expectations of the banks and regulators. Even though a bank may have sold a consumer's debt to a third party, consumers often continue to view themselves as the bank's customers and may have other relationships with that bank. As a result, the debt collector's behavior affects the bank's reputation. Failure to implement proper controls and governance that effectively manage these activities represent safety and soundness and compliance concerns for the OCC. The *Comptroller's Handbook* on "Other Consumer Protection Laws and Regulations" describes a bank's obligations under the Fair Debt Collection Act when conducting debt collection activities.[4] The OCC has also published guidance to banks that provides principles for effectively managing risks associated with vendors and third-party service providers, which also applies to third-party vendors collecting debt on behalf of the banks (debt placement

[3] See "Chase Halts Card Debt Sales of Crackdown," *American Banker*, July 1, 2013. http://www.americanbanker.com/issues/178_126/chase-halts-card-debt-sales-ahead-of-crackdown-1060326-1.html.

[4] See "Comptroller's Handbook on Other Consumer Protection Laws and Regulations," August 2009. http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/other.pdf

relationships) and is also relevant to their relationships with buyers of their debt (debt sales relationships).[5]

The OCC has expressed concern about operational risk at banks on a number of occasions.[6] While operational risk includes a range of activities, the Comptroller specifically raised concerns with debt collection in May 2012 when he noted that the OCC has "seen institutions outsourcing such functions as debt collection but not taking adequate care to ensure that the third-party contracted to perform those functions follows the laws and regulations governing them."[7]

The OCC's current interest in debt collection and debt sales activities stems from our 2010 examination work on mortgage servicing and foreclosure practices that revealed weak governance of third-party vendors, including notaries and affiants, and poor documentation practices more generally. Because of the similarities in processes and heavy reliance on third parties, outside attorneys, notaries, and affiants, the agency was concerned that similar weaknesses might be present in other retail lending activities. As a result, the OCC commenced a review of debt collection and sales activities across the large banks it regulates in April 2011, focusing primarily on notary and affiant practices. The review sought assurance that bank management had implemented necessary governance and control processes in this area. Throughout the summer of 2011, additional work continued in this area stressing the agency's concerns and communicating them to large bank management.

Through its more recent work on debt sales, the OCC identified a number of best practices that OCC large bank examiners are incorporating into their supervision of debt sales

[5] See OCC 2001-47, "Risk Management of Third Party Relationships." See http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html.
[6] See Remarks by Deputy Comptroller for Operational Risk Carolyn DuChene, http://www.occ.gov/news-issuances/speeches/2013/index-2013-speeches.html.
[7] See http://www.occ.gov/news-issuances/speeches/2012/pub-speech-2012-77.pdf.

activities. A copy of these best practices is included in the appendix to this statement. The OCC uses such best practices and insights gained from its on-site supervisory activities to inform the development of policy rules and guidance that may be more applicable to a broader range of financial institutions. As described later in this statement, efforts are currently underway to develop such guidance.

The best practices document provides a practical description of effective risk management practices examiners should expect to see in large banks with debt sales activities. Such practices should include the establishment of detailed policies and procedures to govern debt sales practices consistently across the organization. Those policies and procedures should:

- require financial analysis of why selling the debt is a better option than collecting debt internally;
- identify types of accounts that should not be sold and specify quality standards and quality control for debt that is sold, emphasizing the accuracy of the account balances;
- ensure the purchase and sale agreements clearly delineate roles and responsibilities of all parties for fair debt collection;
- require detailed documentation to ensure accurate and reliable information is provided to the debt buyer at the time of purchase;
- specify internal bank documentation retention practices; and
- address due diligence requirements of third parties to ensure compliance with the bank's own policies and procedures.[8]

[8] We recognize that debt buyers generally are not third-party vendors subject to OCC jurisdiction. Nonetheless, many of the principles enunciated in connection with risk management of third party vendors are relevant to ensuring that a bank has adequate policies and procedures in place to manage risks associated with debt sales.

Due diligence reviews and ongoing monitoring of potential debt buyers are particularly important in managing the reputational risk associated with debt sales activities. Appropriate due diligence reviews should occur before the sale. The reviews should answer questions such as whether debt buyers have appropriate licenses; whether there are existing regulatory and legal actions against the debt buyer or its owners; and whether they are in good standing. In addition to these general governance activities characteristic of sound risk management, the document also includes a variety of specific actions that reflect best practices seen by examiners across large banks:

- *Establish oversight committee*—an oversight body to monitor third party debt buyers and provide a corresponding single, consistent control structure for overall consumer debt sales within an institution.
- *Use debt buyer scorecards*—enhanced controls to assess legal and reputation risk of the debt buyer that takes into consideration consumer complaints, repurchases, legal actions filed against the company, and other regulatory compliance issues.
- *Maintain account accuracy and documentation*—confirm the accuracy of account balances, confirm marketable title that is free and clear from all liens, and confirm the completeness and accuracy of account documentation prior to debt sales.
- *Use clear, consistent contract terminology*—use boilerplate contract language across lines of businesses when appropriate.
- *Provide sufficient documentation*—sufficient documentation will allow fair and informed collection of debts including relevant customer account codes and explanation of codes that should alert a debt buyer to special handling of certain accounts (e.g., attorney handling, etc.).

- *Limit the resale of debt*—contractually limiting the ability of the third party to resell the debt to another entity allows the bank to control who ultimately will pursue collection from "their" customers and helps prevent legal validity and ownership questions later.
- *Limit the litigation strategy*—banks should evaluate the litigation strategies of debt buyers, consider selecting debt buyers who limit their use of litigation, or use contractual provisions or other means to limit the use of litigation by buyers of their debt.
- *Maintain quality Management Information Systems*—establish appropriate management reporting that tracks debt sales, sales price, and repurchase causes and volume.
- *Conduct periodic reviews*—depending on past practices and controls, a look-back review may be required to determine if prior practices resulted in consumer harm.

Specific debt sales practices vary from bank to bank as does the degree to which banks have implemented controls and procedures consistent with those in the best practices document. Weaknesses in debt sales activities stem from several sources. Many of the largest institutions have acquired other institutions, resulting in data quality and integrity issues and a collection of acquired systems that have been difficult to integrate. In some cases, customer account history in these legacy portfolios is not complete.

Consistent with the OCC's heightened expectations for large banks overall, the agency is raising its expectations with regard to the banks' oversight and management of their debt sales activities. For example, while banks continue to work through integration issues, the OCC has emphasized the need for rigorous quality control processes and strong audit programs. The OCC has planned supervisory activities in the largest banks to assess policies, internal monitoring, and oversight of debt sale programs. Where OCC has been informed of planned Consumer Financial Protection Bureau (CFPB) reviews, resident OCC teams will collaborate with CFPB bringing both a safety and soundness and a consumer protection focus to these reviews. Where examiners find unsafe and unsound practices, practices that fail to comply with applicable laws or regulations, or practices that fail to meet our heightened expectations; the OCC will take appropriate supervisory action, including enforcement actions when warranted. Where the agency becomes aware of concerns with nonbank, third party debt collectors, it will refer those issues to the CFPB, which has jurisdiction over those types of entities.

Policy Implications

While supervisory action continues, the OCC recognizes the need for clear, actionable, and effective policy regarding debt sales among all national banks and federal savings associations that engage in this activity. The OCC is in the process of developing supervisory guidance that outlines safe and sound banking principles that should be followed in connection with sales of charged-off consumer debt. The guidance will outline risk management expectations for banks so they can appropriately assess and prudently manage the operational, compliance, and reputational risks associated with this activity and implement appropriate practices to address and mitigate those risks.

The OCC expects a bank's sale of charged-off consumer debt to be structured and operated in a prudent and safe and sound manner that continues to ensure fair treatment of the affected customers. The OCC's guidance will detail the principles that OCC-supervised institutions will be expected to apply in their risk management processes, policies, and procedures regarding disposing of charged-off consumer debts. The principles articulated in the guidance will provide banks with appropriate flexibility in their business decisions regarding non-performing consumer debts, while ensuring that their practices do not enable third party debt buyers to create unnecessary hardships for consumers through their actions after the acquisition of these charged-off debts.

Conclusion

Debt collection is a fundamental part of the business of lending. While banks must carefully underwrite the loans they make by considering the ability and willingness of the borrower to repay that debt, lending retains the inherent risk of borrowers failing to repay their debt. When that occurs, banks have the responsibility to attempt to collect that debt and to recover losses associated with that bad debt. They must do this in a manner that is not only safe and sound, but fair to their customers and in compliance with applicable laws and regulations.

In seeking to recover their losses, banks should exercise particular care when they choose to sell that debt to third party debt collectors. Selling debt to third party debt collectors carries particular compliance, reputational, and operational risks. The OCC has highlighted these risks on a number of occasions and while the industry continues to heal from the credit and capital market challenges of the financial crisis, it is evident that these risks are gaining increasing prominence. For this reason, the OCC has raised its expectations for banks to provide effective risk management over all facets of their operations and activities. Meeting those expectations will require additional effort and investment on the part of the banks, but we are confident that they can meet those expectations, and we will insist that they do.

Appendix 1 -- Debt Sales / Best Practices

Topics

I. Background

Banks have used debt sales (i.e., charged-off assets) as a management tool to control problem credit resolutions and improve recovery numbers in a timely and cost effective manner. In a debt sale, accounts are sold outright to a third party with the sales price generally based on a small percentage of the outstanding balances and the third party retaining 100 percent of the collected amount. Debt sales are generally arranged through an individual bulk sale or contractual forward-flow agreements. Debt sales require increased due diligence and enhanced controls to limit the bank's reputation and legal risks.

II. Policies and Procedures

A sound management control structure includes detailed policies and procedures to promote a consistent process across the organization. Items to consider within an effective policy or procedures include:

- The policy should describe who is responsible for debt sales across the organization (e.g., Corporate Credit, Ops Risk, Steering Committee, etc.).
- Require the involvement of various bank risk personnel in the debt sale approval process to ensure all risks are considered (i.e. compliance, information technology, credit, legal, collections, finance, recovery, information security, etc.). Each debt sale should go through a formal approval process that is similar to a product approval process.
- Require a financial analysis of why selling the debt is better than collecting the debt internally.
- Detail documentation requirements to ensure accurate and reliable information is provided to the debt buyer at time of purchase. In addition, the policy should outline internal bank documentation retention standards.
- The policy should address initial third party due diligence requirements and ongoing due diligence monitoring requirements.

- Require affirmative sign-off by a quality control review function that the debt sale assets meet the characteristics of the purchase and sale agreement and account balances are accurate.
- Outline accounts that should not be sold. Items for consideration include: SCRA; minors (date of birth); settled; deceased with no remaining responsible party; accounts in disaster areas; pending bankruptcy; fraud; accounts close to statute of limitations; accounts lacking clear title; accounts lacking proof of right-to-cure or notice of intent-to-sell letters; balances comprised largely of interest and fees; cease and desist accounts; debts where payments were recently received; and, accounts in ongoing loss mitigation programs (short sales, deed in lieu; etc.).

III. Third Party Due Diligence—Vendor Management

Strong debt sale oversight includes an established initial and ongoing due diligence process of third party debt buyers to help control and limit legal and reputation risk. Management should establish minimum criteria for approving debt buyers and should consider the following:

- Do debt buyers have appropriate licenses to operate across various state jurisdictions?
- Is the debt buyer an established business? What is the length of time the debt buyer is required to be in business by bank standards?
- Does the debt buying entity have audited financial statements? Are they financially sound and not under undue financial distress?
- Are any regulatory or legal actions currently taken against the debt buyer or its owners/principals raising concerns or issues? Are the debt buyers and owners/principals in good standing (e.g., National Association of Retail Collection Attorneys (NARCA))?
- Are collection activities primarily performed in-house or are they outsourced? What activities can be outsourced—bankruptcy filing, repossessions, litigation activities, skip tracing, etc? Does the company off-shore collection processes?
- Determination of how often legal actions are performed by the debt buyer in an effort to collect debt (consider placing litigation limits within the contract)?
- For forward flow agreements, can the debt buyer demonstrate the needed liquidity to purchase future debt sales?
- Does the debt buyer carry sufficient insurance (i.e. commercial liability and errors and omissions policy)?
- Are debt buyers prohibited from reselling accounts? If they are not prohibited, what additional controls are required within the original purchase and sales agreement?
- Management should maintain a file on approved debt buyer with supporting documentation to meet OCC vendor management expectations. See *OCC Bulletin 2001-47 Third Party Relationships: Risk Management Principles* for additional information.

Management should consider the following items when performing an onsite inspection of the debt buying entity:

- Business culture;
- Management and business structure;

- Regulatory and compliance—FDCPA, SCRA, FCRA, Telephone Consumer Protection Act, BK, Fraud, and Deceased;
- Quality of internal quality control function;
- Qualified legal staff;
- How consumer complaints are handled and tracked;
- Collection training—handbooks, procedures, and job aids;
- Consumer privacy policy;
- Information, data, and physical security;
- Regulatory communication;
- Communications are state compliant (i.e., letters, phone calls); and,
- Call or collection attempt frequency.

Ongoing due diligence should consider:

- Reviewing annual financial statements of the buying entity to ensure ongoing financial strength.
- The buying entity and its principal/owners remain in good standing.
- If there are any significant changes in processes, operations, or personnel.
- The volume and type of consumer complaints, as well as applicable remediation.
- The volume and reason of repurchases.

IV. Quality Control and Audit—Internal Controls

A strong risk structure includes a quality control function that evaluates debt sales prior to the sale. This function should evaluate "data scrubs" to validate and ensure account data is complete and accurate and the account data is updated from the system of record. A transaction sample at an account level should be completed prior to the debt sale. In addition, quality control should ensured account characteristics are maintained as specified in the purchase and sales agreement. Finally, quality control should assess the reason accounts are repurchased after a debt sale is completed, and determine if additional controls are required.

Audit should evaluate compliance with debt sale policy or procedures and evaluate vendor management compliance. Audit or quality control should ensure the credit bureau reporting is updated and accurate reflecting the sale or transfer of the debt.

V. Contract Terminology

Management should consider having a standard (i.e., boilerplate) debt sales contract for bulk and forward flow debt sales for use across business lines to ensure consistent debt sales treatment. Contract language should confirm the accuracy of account balances, confirm marketable title that is free and clear from all liens, and confirm the completeness and accuracy of account documentation. Account documentation should be sufficient to allow the debt buyer to collect accounts in the normal course of business without having to request additional documentation; however, the contract should address when additional documentation requests are required (e.g., litigation). Best practice would provide subsequent information requests for no charge, or a minimal charge once a certain threshold is reached. The bank needs to avoid the appearance of not providing the debt buyer with sufficient and appropriate information to collect debt in compliance with federal and state regulations. In this regard, bank management must supply relevant codes and an explanation of the codes (e.g., codes that indicate special handling—don't call at work, attorney handling, etc.).

The contract should spell out the debt buyer must comply with the various consumer laws and standards, such as: FDCPA; FCRA; UDAP, TCPA (Telephone Consumer Protection Act); SCRA; cease and desist—no calls at work; etc. The contract should spell out when and under what circumstances the bank will repurchase accounts. In addition, it should allow the bank the ability to conduct ongoing, at least annual field visits. Finally, a best practice is to limit the volume of accounts the debt buyer can litigate and spell this out within the contract.

VI. Accounting and Reserves

Management should determine if reserves are required given the size and type of debt sales and expected repurchase risk or losses. Reserves should be established in accordance with GAAP. In addition, maintaining standard contract language would assist in the reserve process helping to eliminate the need to review each debt sale individually for different terms and conditions.

VII. Best Practices

- *Debt buyer scorecards*—enhanced controls to assess legal and reputation risk of the debt buyer that takes into consideration consumer complaints, repurchases, legal actions filed against the company, and other regulatory compliance issues.
- *Established oversight committee*—an oversight body to oversee third party debt buyers and corresponding control structure.
- *Contract terminology*—confirm the accuracy of account balances, confirm marketable title that is free and clear from all liens, and confirm the completeness and accuracy of account documentation. Also, the use of boilerplate contract language across lines of businesses when appropriate.
- *Documents*—provide sufficient documentation to the debt buyer that will allow the collection of debts including relevant codes and explanation of codes (e.g., attorney handling, etc.). Some banks are now providing account statements for each account to support account balances.
- *No resale of debt*—limiting the ability of the third party to resell the debt to another entity. By not limiting the resale of debt, the bank does not control who ultimately will collect on "their" customers and the documentary paper trail may become corrupted over time, calling legal validity and ownership into question.
- *Limiting the litigation strategy*—banks should evaluate the litigation strategies of debt buyers and determine when and how often this strategy is used. Does it take into consideration the borrower's ability to pay, is it a model based approach, or is the initial action to litigate all accounts at the very beginning?
- *MIS*—establish appropriate management reporting tracking debt sales by LOB, sales price, and repurchases risk - along with the reason for repurchases.
- *Look-back*—depending on past practices and controls, a look-back review may be required to determine if prior practices resulted in consumer harm.

Debt Placements
Sometimes debts are placed with a third party in an effort to improve collections prior to selling the debt. These debts placements are collected on the bank's behalf with the third party retaining a percentage of the collected amount. Management should establish appropriate policies, procedures, and controls around these debt placements to demonstrate appropriate oversight and due diligence. Many items in this document are also relevant to debt placements.