

# Basel III Exposure Classification: Charge with Lending on Charge Feature

**American Express Company**

May 2013



On October 22, 2012, American Express submitted a comment letter on the treatment of charge and hybrid cards in the proposed rules issued by the federal banking agencies (the “Agencies”) to incorporate Basel III into the Agencies’ advanced approaches capital rule (the “Proposed Rules”). American Express would like to provide additional, relevant data to the Agencies, in support of this comment letter.

American Express maintains an active interest in promoting alignment between regulatory treatment of consumer finance products, their risk profile and value to consumers. “Hybrid accounts” represent a meaningful portion of our product offering (the majority of our US consumer Charge Card accounts have Lending On Charge features and hence fall into this category), and we demonstrate that, controlling for risk of cardmembers, such as their FICO and delinquency status, Charge Cards with and without Lending On Charge features exhibit risk lower than or comparable to that of Credit Cards. Therefore, for Basel purposes, Charge Cards, both with and without Lending On Charge, and with exposures below \$100,000 should be classified **at least** on par with Credit Cards, i.e., as QRE.

- **Overview of Lending On Charge**
- Sizing of AXP US Consumer Card Portfolios
- Risk Performance of AXP US Consumer Lending On Charge over time

# Traditional Charge Cards



- Charge Cards are intended primarily for transaction convenience by providing an alternative to cash at Point of Sale
- Charge Cards also provide additional customer benefits not available to transactions with cash or debit cards, such as protection in case of non-delivery or inadequate quality of goods or services provided by merchants
- Each Charge Card transaction is authorized based upon its expected profitability using recent credit information about the customer and his/her payment and spend patterns
- Charge Cards' full outstanding balance is billed on a monthly basis and is due in full within one month – in other words, Charge Cards allow revolving only for one billing cycle
- High risk, out-of-pattern Charge Card customers are case-setup for review even if their accounts are current
- Furthermore, a very small fraction of Charge Card accounts (high risk and/or high spend accounts) have global limits that limit maximum exposure

# Lending on Charge Feature



- While Charge Cards are not designed to satisfy all lending needs of their customers, some Charge Cardmembers may occasionally need to be able to revolve their balances – for example, while Cardmembers are traveling or in order to extend over time repayment of large purchases
- To address this need, American Express enables on some Consumer Charge accounts (predominantly in the US) an additional feature called Lending On Charge
- American Express offers two types of Lending On Charge features:
  - Some Lending On Charge features automatically sweep certain transactions into the revolving part of the account. Examples include transactions related to travel (e.g., airfare, hotels) or transactions above a certain threshold (e.g., all transactions above \$100)
  - Another type of Lending On Charge feature (called “Select & Pay Later”) allows the Charge Cardmember to select particular transactions and move only those transactions into the revolving part of the account
- Since Lending On Charge allows revolving, it is only offered to Cardmembers with favorable risk characteristics, as assessed by proprietary risk models

# Specifics of Lending On Charge Feature



- Lending on Charge feature is managed within the Charge account and billed through the same statement
- To remain current, Cardmembers must make minimum due payments on their Lending On Charge balances, as well as pay in full their Charge balances
- The maximum balance allowed to revolve on any type of Lending On Charge is subject to a hard limit (typically \$35,000), which is communicated to the customer as part of Terms & Conditions; however, this cap on Lending On Charge balances is not a committed line of credit
- Credit risk associated with the Lending On Charge feature is managed by temporarily suspending the ability of high risk Cardmembers to add new transactions to the revolving balance
- Compared to line reduction on Credit Cards, suspension of Lending On Charge feature has proven to be more customer-friendly, as the customer is still able to use the Pay In Full portion of their Charge account, and to be more effective as a means of controlling default balances

# Card Product Spectrum



Charge Cards with Lending On Charge features lie on the card product spectrum between traditional Charge Cards and Credit Cards



|                       | Traditional Charge Cards                            | Charge Cards with Lending On Charge                                                                                                                                                                                                   | Traditional Credit Cards                                                    |
|-----------------------|-----------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|
| Defined Spend Limit   | No                                                  | No                                                                                                                                                                                                                                    | Yes (Open To Buy = Line Of Credit– Balance)                                 |
| Revolving Allowed     | Balances can be revolved only for one billing cycle | Partial: <ul style="list-style-type: none"> <li>• Pay In Full balances can be revolved only for one billing cycle</li> <li>• Lending On Charge balances can be revolved over time so long as minimum due payments are made</li> </ul> | Balances can be revolved over time so long as minimum due payments are made |
| Defined Revolve Limit | Not Applicable                                      | Lending On Charge balances are subject to caps, but there is no committed Line of Credit                                                                                                                                              | Yes (Line of Credit)                                                        |

# Scope of Subsequent Analyses



- The scope of this document is defined as US Consumer Credit and Charge Card accounts with exposures below \$100,000 (referred to as “QRE Eligible Accounts”). Specifically, at the time of observation the following conditions must be met\*
  - Credit Card Accounts: Line of Credit <\$100,000
  - Charge Card Accounts without Global Limits: Maximum Balance (combined Pay In Full and Lending On Charge) over the last 12 months <\$100,000
  - Charge Card Accounts with Global Limits: Global Limit < \$100,000\*\*
- The geographic scope is limited to the US as Lending On Charge is much less prevalent in American Express’ International portfolios and in general is not offered to Corporate Charge Cards

\* These limits are selected to ensure likelihood of an account satisfying these conditions to develop balance above \$100,000 in the next 12 months is less than 0.5%. Centurion Card Accounts (“Black Cards”), which are designed for wealthy, high spending individuals, are excluded regardless of balance

\*\* Global Limit caps both Pay In Full and Lending On Charge Exposure combined



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- Risk Performance of AXP US Consumer Lending On Charge over time

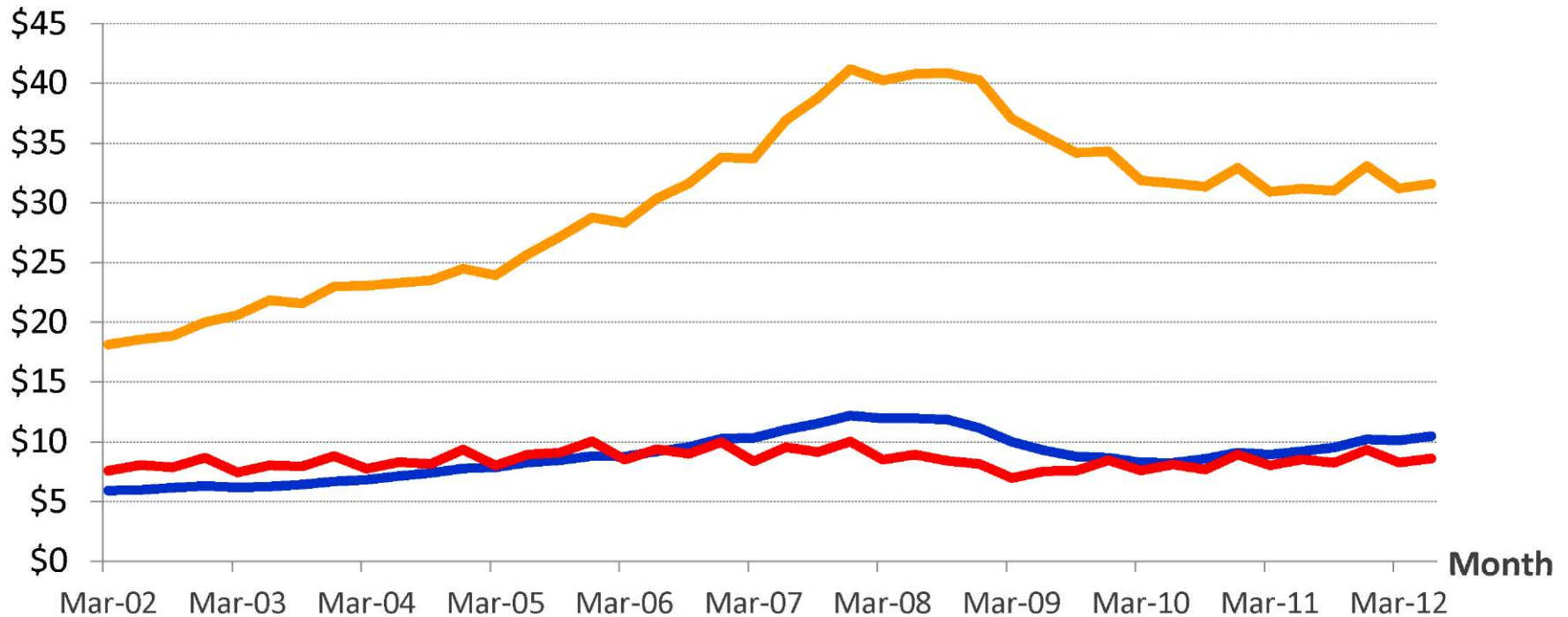
# Overall Balances By Product Type



## US Consumer "QRE-eligible" Card Accounts

**Billed Balance  
(Billions)**

— Lending-On-Charge Balances — Pay-In-Full Charge Balances — Credit Card Balances



- Overview of Lending On Charge
- Sizing of AXP US Consumer Card Portfolios
- **Risk Performance of AXP US Consumer Lending On Charge over time**
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- Lending On Charge and Pay In Full portions of a Charge account are treated as components of the same account
- The analysis includes the following types of accounts
  - Accounts that are not cancelled (i.e., they can be used for transactions), regardless of their balances
  - Accounts that are cancelled but not yet written off, if they have positive balances
- Default is defined as 180 days past due or early write-off (usually due to bankruptcy)
- Since Lending On Feature is a feature of a Charge account, Lending On Charge and Pay In Full portions of the Charge account default together
- When a Charge account defaults, the defaulted balance is defined as the sum of the Lending On Charge and Pay In Full balances at the time of default
- **Gross Dollar Loss Rate** is defined as the sum of defaulted balances in the 12 months after the observation month divided by the sum of the balances in the observation month (recoveries not included)
- **Event Default Rate** is defined as the number of accounts that defaulted in the 12 months after the observation month divided by the starting number of accounts in the observation month

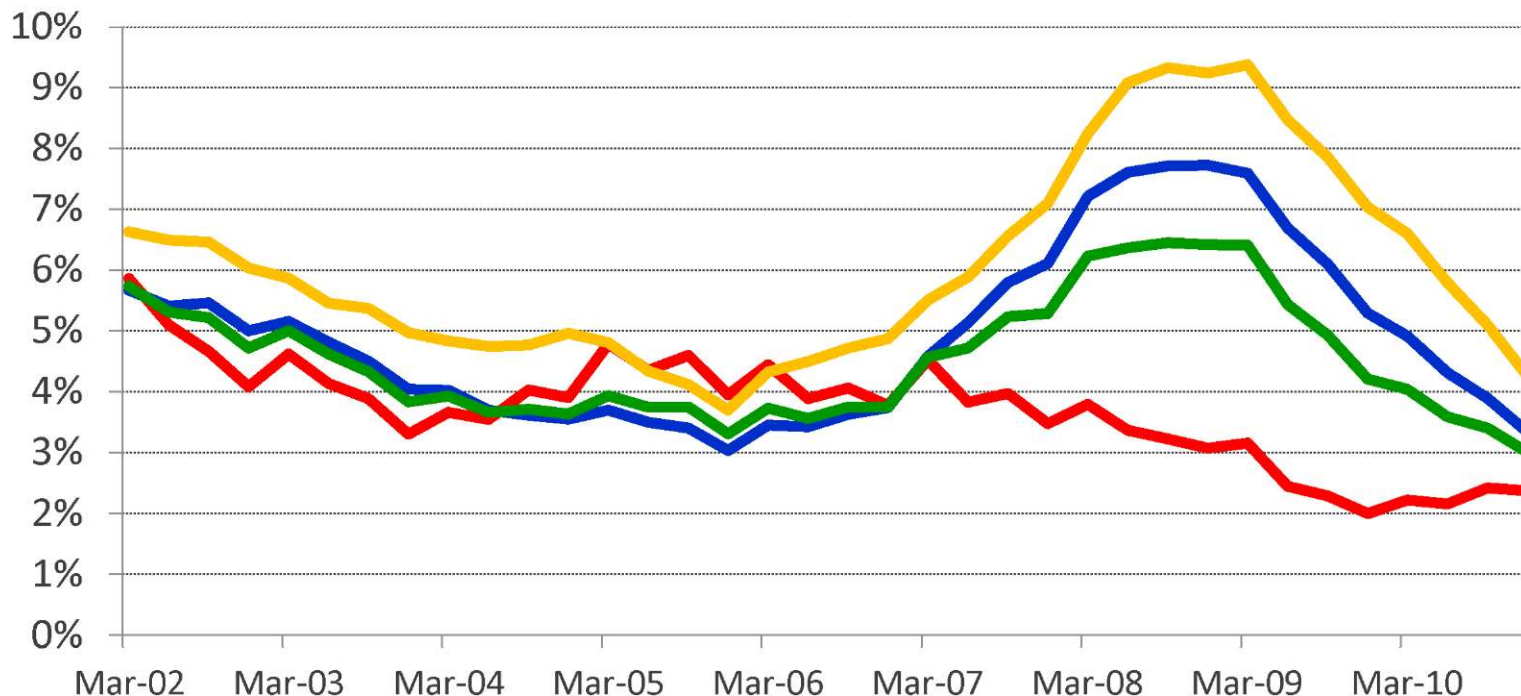
# Historical Gross Dollar Loss Rates



Charge Cards have lower and less volatile credit losses

## US Consumer "QRE-eligible" Card Accounts

- Charge accounts using Lending-On-Charge feature
- Charge accounts not using Lending-On-Charge feature
- All Charge Card accounts
- Credit Card accounts



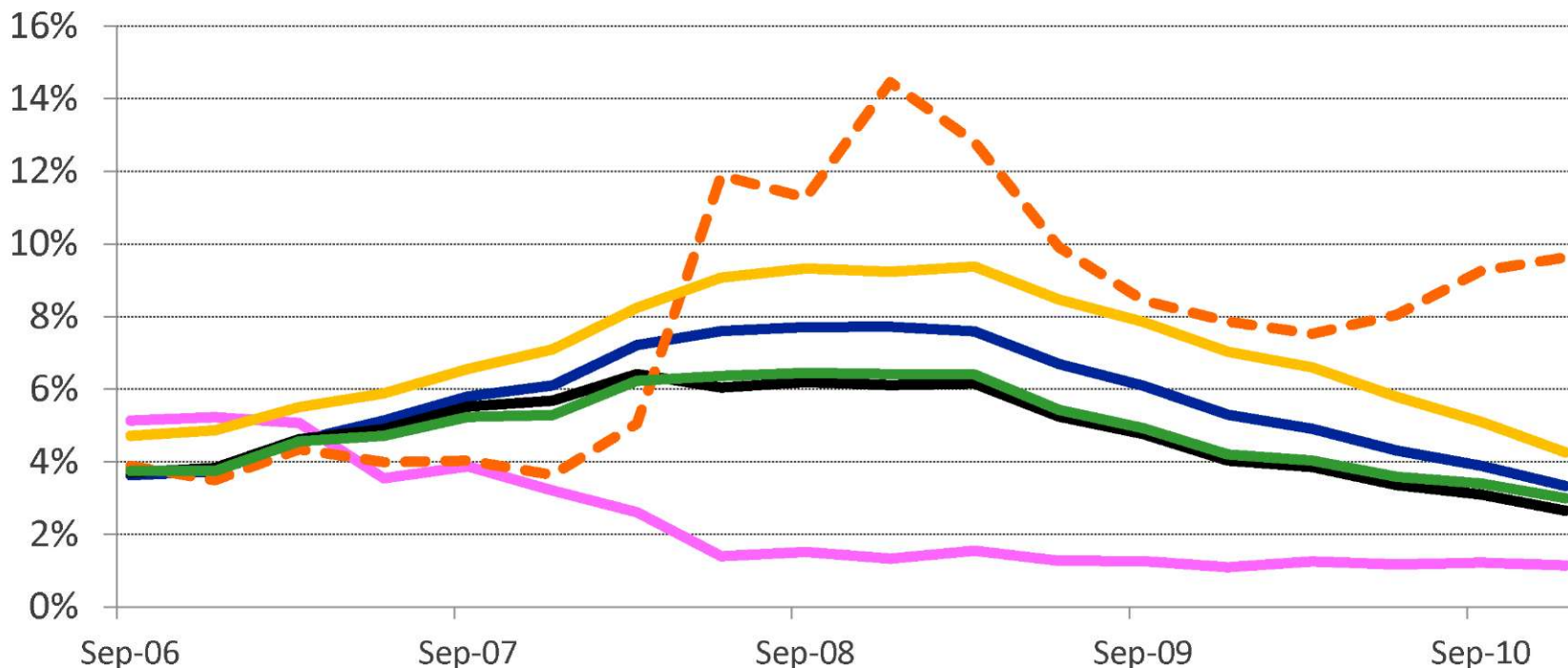
# Historical Gross Dollar Loss Rates



Charge Cards that have the optional Lending On Charge feature (“Select & Pay Later”) but do not use it are the lowest risk

## US Consumer “QRE-eligible” Card Accounts

- Charge accounts using Lending-On-Charge feature
- All Charge Accounts with Lending-On-Charge
- All Charge Card accounts
- Charge accounts with optional Lending-On-Charge feature but not using it
- Charge accounts without Lending On Charge feature
- Credit Card accounts



# Historical Event Default Rates

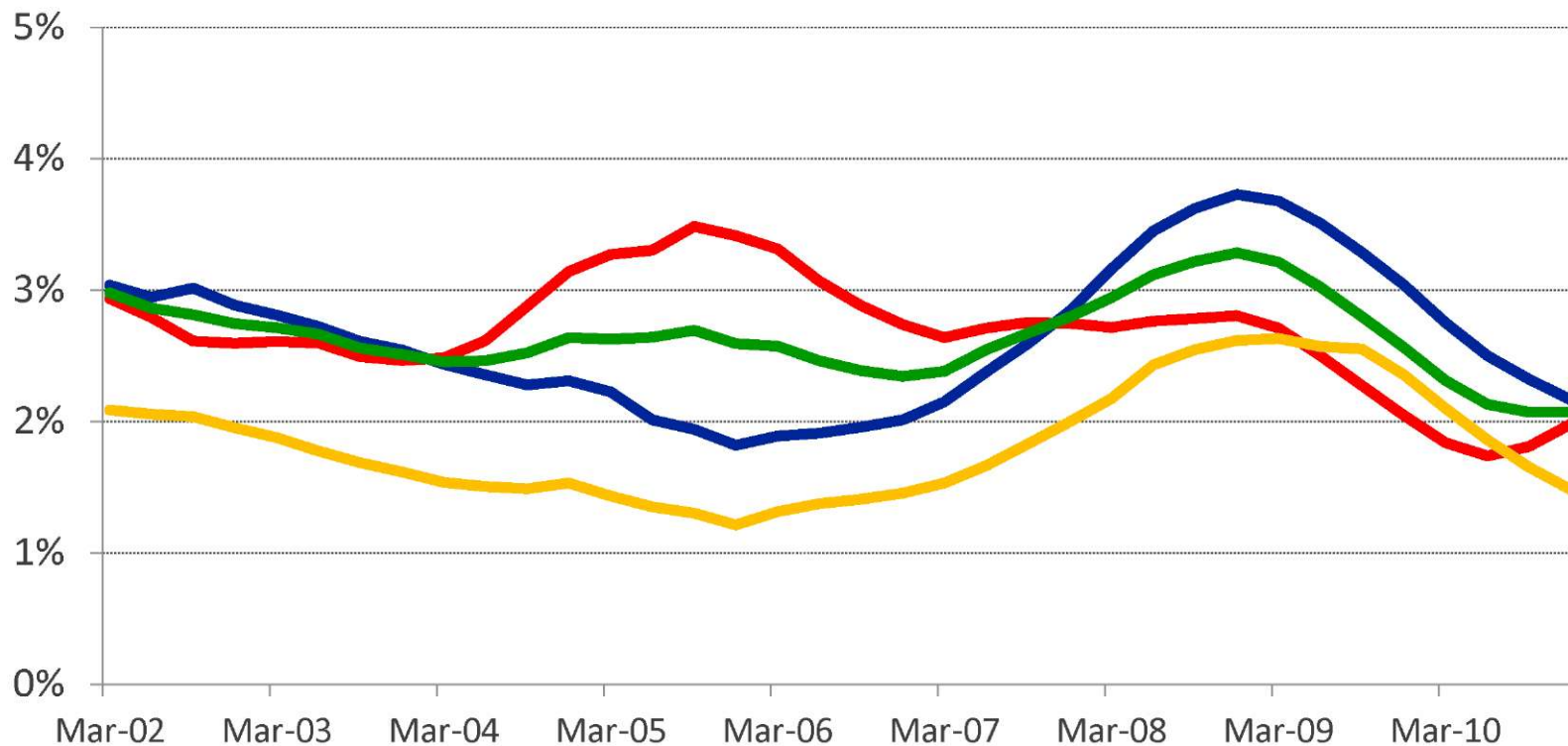


Credit Cards have lower default rates than Charge Cards, largely due to the large number of inactive accounts (please see the next page)

## US Consumer "QRE-eligible" Card Accounts

**Default Rate**

- Charge accounts using Lending-On-Charge feature
- Charge accounts not using Lending-On-Charge feature
- All Charge Card accounts
- Credit Card accounts



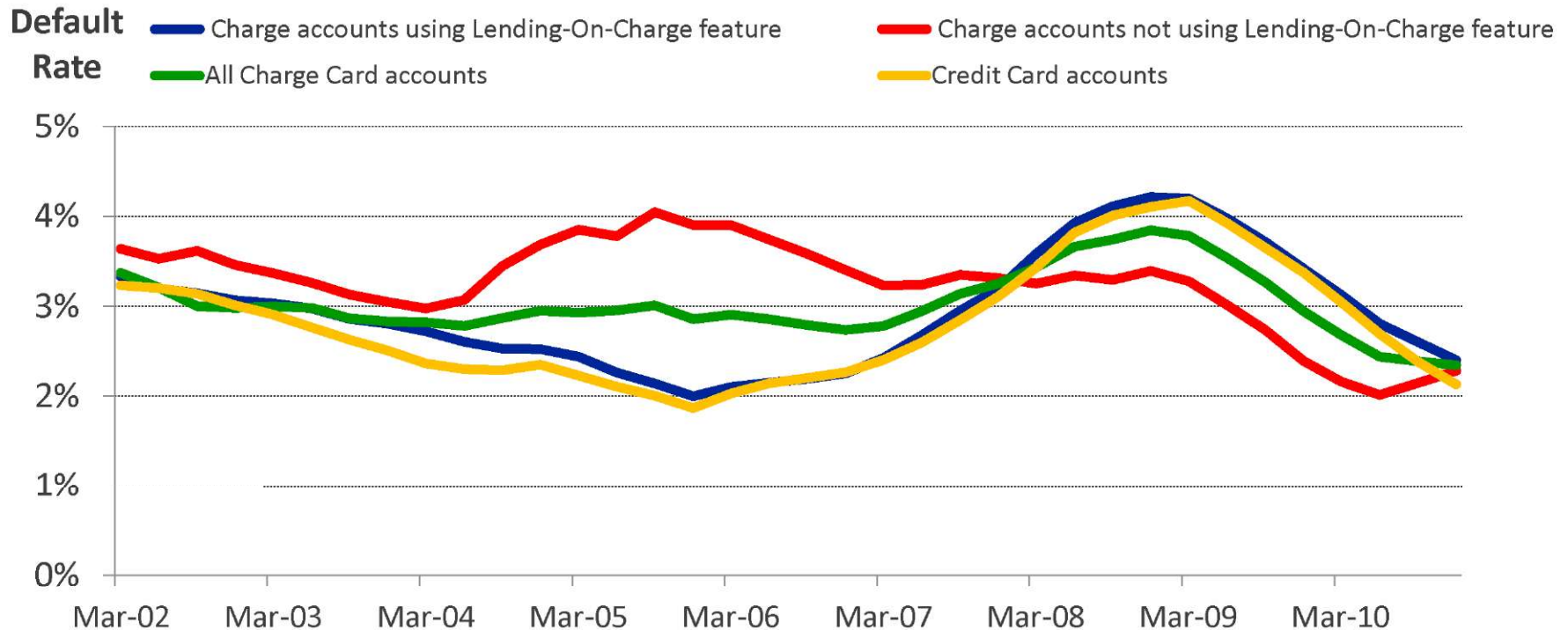
# Historical Event Default Rates Controlling For Inactive Accounts



Credit Cards have a higher proportion of inactive accounts compared to Charge Cards (many Credit Cards are free, while Charge Cards have annual fees).

If one only looks at accounts with positive balances (active accounts), then the default rates for Charge and Credit Cards become comparable.

## US Consumer "QRE-eligible" Card Accounts





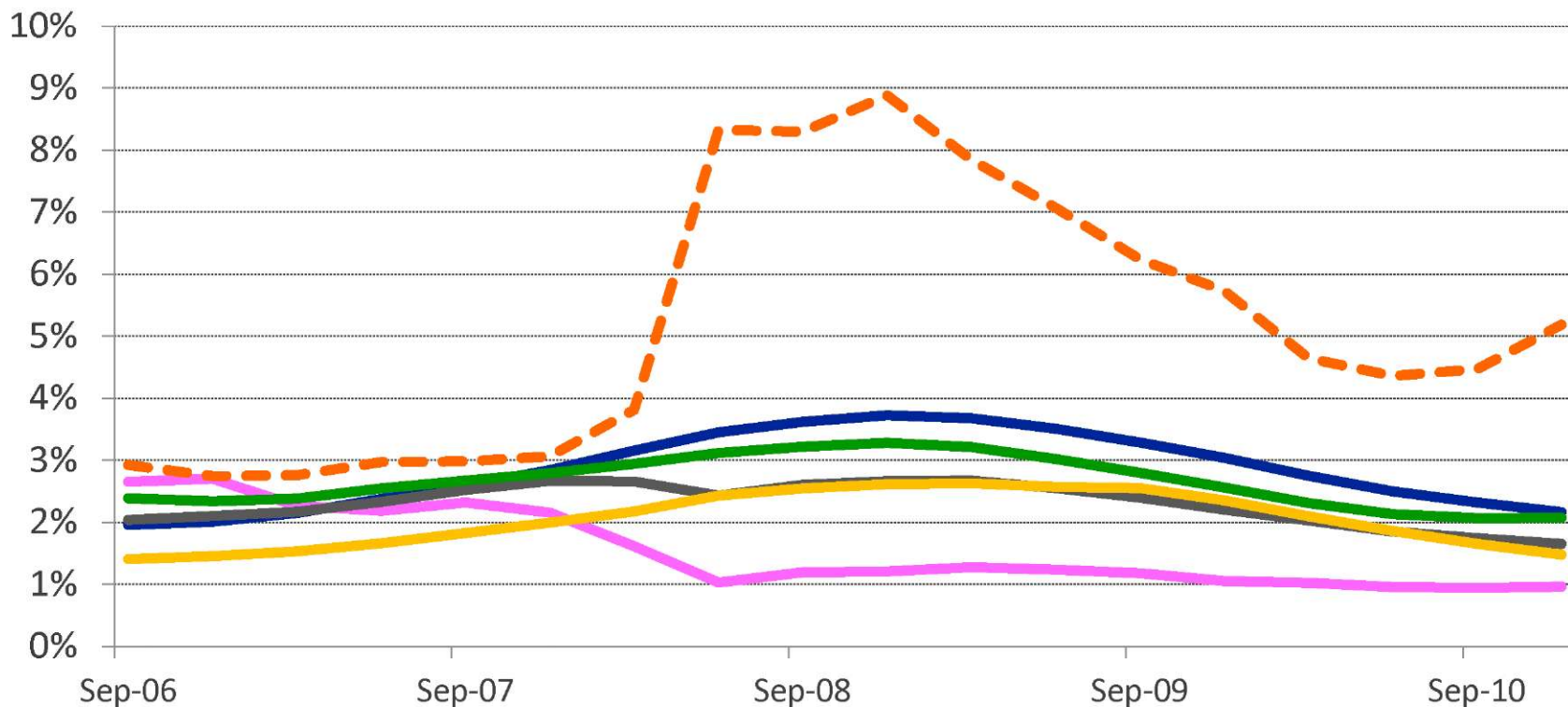
# Historical Event Default Rates



Charge Cards without Lending On Charge feature are mostly cardmembers who are high risk and hence ineligible for Lending on Charge – therefore their default rate is higher than that of the overall population

## US Consumer “QRE-eligible” Card Accounts

- Charge accounts using Lending-On-Charge feature
- All Charge Accounts with Lending-On-Charge
- All Charge Card accounts
- Charge accounts with optional Lending-In-Charge feature but not using it
- Charge accounts without Lending On Charge feature
- Credit Card accounts



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- **Risk Performance of AXP US Consumer Lending On Charge over time**
  - Loss Rates and Default Rates
  - **Measures of Volatility**

# Definition of Segments



- The following segmentation by FICO and Account Age (Delinquency status) was used:
  - Account Age: Less than 1 cycle delinquent, FICO: <650
  - Account Age: Less than 1 cycle delinquent, FICO: 650-750
  - Account Age: Less than 1 cycle delinquent, FICO: >750
  - Account Age: 1 cycle or more delinquent
- The following time windows were used:
  - 2002-2010: Overall comparison between Charge Cards with and without Lending On Charge Balances and Credit Cards
  - 2006-2010: Additional breakdown between Charge Cards with Lending On Charge feature and using it and Charge Cards with Lending On Charge feature but not using it (enrollment into the optional “Select & Pay Later” feature became sizable in 2006)

# Definition of Volatility Metrics



- Start with the observed Quarterly\* Default Rates

- **Coefficient of Variation (CoV)** is calculated simply as

$$\text{CoV} = \text{Standard Deviation of Default Rate} / \text{Average Default Rate}$$

- **Asset Value Correlation (Rho)** is calculated using the standard Merton-Vasicek approach
  - Transform the Default Rate time series by calculating  $\text{NORMSINV}(\text{Default Rates})^*$
  - Calculate Standard Deviation (StDev) of the transformed time series
  - $\text{Rho} = \text{StDev}^2 / (1 + \text{StDev}^2)$

\* Quarterly is used to optimize the trade-off between the number of observations and impact of autocorrelation in the time series due to overlapping of 12-month windows used to calculate default rates

\*\* NORMSINV is Inverse of Normal Standard Cumulative Distribution Function

- This section compares volatility metrics for Charge accounts with and without Lending On Charge features and compares them to credit loss trends of Credit Card portfolios.
- We calculate these metrics by FICO and delinquency segments defined on p.19 in order to control for the risk composition of different products
  - Overall, Charge Cards have lower volatility than Credit Cards (both Coefficient of Variation and Asset Value Correlation)
  - Charge Cards, which have the optional Lending On Charge feature enabled but do not use it, have the lowest volatility
  - Charge Cards, which use Lending On Charge, exhibit volatility comparable to that of Credit Cards. Volatility of Charge Cards that use Lending On Charge is closer to that of Co-Branded Credit Cards, since both product categories have annual fees, which reduces the number of inactive accounts.
  - Charge Cards without Lending On Charge are mostly cardmembers who are high risk and hence ineligible for Lending On Charge
- We compare risk of American Express' US Consumer Charge portfolios to that of its two US Consumer Credit cards portfolios:
  - Co-Branded Credit Cards, which, similar to Charge Cards, have annual fees and whose value proposition is targeted to transactors
  - Proprietary Credit Cards, many of which historically have not had annual fees, and which are often preferred by revolvers

# High FICO Segment



Both Charge Cards using Lending On Charge and Charge Cards not using Lending On Charge exhibit volatility lower than that of Credit Cards

## US Consumer “QRE-eligible” Card Accounts

Time period: March-2002 through December-2010

Segment:

- Less than 1 cycle delinquent
- FICO > 750

|                            | Charge not using LOC | Charge using LOC | Charge All | Proprietary Credit Cards | Co-branded Credit Cards |
|----------------------------|----------------------|------------------|------------|--------------------------|-------------------------|
| Mean                       | 0.3%                 | 0.3%             | 0.3%       | 0.2%                     | 0.2%                    |
| St. Deviation              | 0.04%                | 0.07%            | 0.04%      | 0.07%                    | 0.05%                   |
| CoV                        | 16.2%                | 21.8%            | 16.1%      | 34.5%                    | 33.9%                   |
| Rho                        | 0.3%                 | 0.5%             | 0.3%       | 0.9%                     | 0.8%                    |
| Balances (\$Bil)<br>Dec-10 | 3.9                  | 5.6              | 9.5        | 5.3                      | 9.4                     |

# High FICO Segment

## Usage Of Optional Lending On Charge Feature



Charge Cards with Lending On Charge feature show volatility lower than or comparable to that of Credit Cards

### US Consumer “QRE-eligible” Card Accounts

Time period: September-2006 through December-2010

Segment:

- Less than 1 cycle delinquent
- FICO > 750

|                         | Charge with optional LOC but not using it | Charge with LOC and using it | All Charge with LOC | Charge without LOC | All Charge | Proprietary Credit Cards | Co-branded Credit Cards |
|-------------------------|-------------------------------------------|------------------------------|---------------------|--------------------|------------|--------------------------|-------------------------|
| Mean                    | 0.3%                                      | 0.3%                         | 0.3%                | 0.3%               | 0.3%       | 0.2%                     | 0.1%                    |
| St Deviation            | 0.0%                                      | 0.1%                         | 0.0%                | 0.1%               | 0.0%       | 0.0%                     | 0.0%                    |
| CoV                     | 11.6%                                     | 16.4%                        | 11.9%               | 18.5%              | 14.3%      | 17.4%                    | 12.3%                   |
| Rho                     | 0.2%                                      | 0.3%                         | 0.2%                | 0.4%               | 0.2%       | 0.3%                     | 0.1%                    |
| Balances (\$Bil) Dec-10 | 3.6                                       | 5.6                          | 9.2                 | 0.3                | 9.5        | 5.3                      | 9.4                     |

# Medium FICO Segment



Both Charge Cards using Lending On Charge and Charge Cards not using Lending On Charge exhibit volatility lower than that of Credit Cards

## US Consumer “QRE-eligible” Card Accounts

Time period: March-2002 through December-2010

Segment:

- Less than 1 cycle delinquent
- FICO : Between 650 and 750

|                         | Charge not using LOC | Charge using LOC | Charge All | Proprietary Credit Cards | Co-branded Credit Cards |
|-------------------------|----------------------|------------------|------------|--------------------------|-------------------------|
| Mean                    | 1.2%                 | 1.5%             | 1.4%       | 1.5%                     | 1.1%                    |
| St. Deviation           | 0.4%                 | 0.7%             | 0.5%       | 0.5%                     | 0.5%                    |
| CoV                     | 31.5%                | 44.1%            | 37.7%      | 35.8%                    | 48.0%                   |
| Rho                     | 1.6%                 | 2.6%             | 1.9%       | 1.7%                     | 2.8%                    |
| Balances (\$Bil) Dec-10 | 1.9                  | 5.0              | 6.9        | 7.6                      | 6.7                     |



# Medium FICO Segment Usage Of Optional Lending On Charge Feature



Charge Cards with Lending On Charge feature show volatility lower than or comparable to that of Credit Cards

## US Consumer “QRE-eligible” Card Accounts

Time period: September-2006 through December-2010

Segment:

- Less than 1 cycle delinquent
- FICO between 650 and 750

|                         | Charge with optional LOC but not using it | Charge with LOC and using it | All Charge with LOC | Charge without LOC | All Charge | Proprietary Credit Cards | Co-branded Credit Cards |
|-------------------------|-------------------------------------------|------------------------------|---------------------|--------------------|------------|--------------------------|-------------------------|
| Mean                    | 1.2%                                      | 2.0%                         | 1.7%                | 2.0%               | 1.8%       | 1.8%                     | 1.5%                    |
| St Deviation            | 0.1%                                      | 0.6%                         | 0.4%                | 0.9%               | 0.5%       | 0.5%                     | 0.5%                    |
| CoV                     | 7.5%                                      | 29.9%                        | 23.4%               | 43.3%              | 26.4%      | 29.1%                    | 30.3%                   |
| Rho                     | 0.1%                                      | 1.8%                         | 1.0%                | 4.0%               | 1.3%       | 1.6%                     | 1.7%                    |
| Balances (\$Bil) Dec-10 | 1.5                                       | 5.0                          | 6.5                 | 0.4                | 6.9        | 7.6                      | 6.7                     |

# Low FICO Segment



Both Charge Cards using Lending On Charge and Charge Cards not using Lending On Charge exhibit volatility lower than that of Credit Cards

## US Consumer “QRE-eligible” Card Accounts

Time period: March-2002 through December-2010

Segment:

- Less than 1 cycle delinquent
- FICO < 650

|                         | Charge not using LOC | Charge using LOC | Charge All | Proprietary Credit Cards | Co-branded Credit Cards |
|-------------------------|----------------------|------------------|------------|--------------------------|-------------------------|
| Mean                    | 7.0%                 | 7.7%             | 7.3%       | 8.3%                     | 7.8%                    |
| St. Deviation           | 1.2%                 | 2.5%             | 1.6%       | 2.3%                     | 2.6%                    |
| CoV                     | 17.0%                | 32.3%            | 22.4%      | 27.2%                    | 33.5%                   |
| Rho                     | 0.8%                 | 2.7%             | 1.3%       | 2.0%                     | 2.9%                    |
| Balances (\$Bil) Dec-10 | 0.3                  | 0.8              | 1.1        | 1.6                      | 1.3                     |

# Low FICO Segment Usage Of Optional Lending On Charge Feature



Charge Cards with Lending On Charge feature show volatility lower than or comparable to that of Credit Cards

## US Consumer “QRE-eligible” Card Accounts

Time period: September-2006 through December-2010

Segment:

- Less than 1 cycle delinquent
- FICO < 650

|                            | Charge with optional LOC but not using it | Charge with LOC and using it | All Charge with LOC | Charge without LOC | All Charge | Proprietary Credit Cards | Co-branded Credit Cards |
|----------------------------|-------------------------------------------|------------------------------|---------------------|--------------------|------------|--------------------------|-------------------------|
| Mean                       | 6.2%                                      | 9.7%                         | 8.8%                | 8.4%               | 8.6%       | 10.1%                    | 10.1%                   |
| St Deviation               | 1.0%                                      | 1.9%                         | 1.7%                | 1.4%               | 1.3%       | 1.9%                     | 1.9%                    |
| CoV                        | 15.6%                                     | 20.1%                        | 19.7%               | 16.8%              | 15.2%      | 19.0%                    | 18.7%                   |
| Rho                        | 0.6%                                      | 1.4%                         | 1.2%                | 0.9%               | 0.7%       | 1.3%                     | 1.2%                    |
| Balances (\$Bil)<br>Dec-10 | 0.1                                       | 0.8                          | 0.9                 | 0.2                | 1.1        | 1.6                      | 1.3                     |

# Delinquent Segment



Charge Card delinquent segments exhibit much lower risk than Credit Cards as more delinquent Charge Cards accounts roll back without defaulting

## US Consumer “QRE-eligible” Card Accounts

Time period: March-2002 through December-2010

Segment:

- 1 cycle or more delinquent
- All FICO

|                         | Charge not using LOC | Charge using LOC | Charge All | Proprietary Credit Cards | Co-branded Credit Cards |
|-------------------------|----------------------|------------------|------------|--------------------------|-------------------------|
| Mean                    | 35.2%                | 39.0%            | 37.2%      | 66.1%                    | 53.2%                   |
| St. Deviation           | 3.7%                 | 9.3%             | 5.8%       | 7.2%                     | 8.9%                    |
| CoV                     | 10.6%                | 23.9%            | 15.6%      | 10.9%                    | 16.7%                   |
| Rho                     | 1.0%                 | 5.6%             | 2.2%       | 4.0%                     | 5.0%                    |
| Balances (\$Bil) Dec-10 | 0.1                  | 0.3              | 0.4        | 0.4                      | 0.3                     |

# Delinquent Segment Usage Of Optional Lending On Charge Feature



Charge Card delinquent segments exhibit much lower risk than Credit Cards as more delinquent Charge Cards accounts roll back without defaulting

## US Consumer “QRE-eligible” Card Accounts

Time period: September-2006 through December-2010

Segment:

- 1 cycle or more delinquent
- All FICO

|                         | Charge with optional LOC but not using it | Charge with LOC and using it | All Charge with LOC | Charge without LOC | All Charge | Proprietary Credit Cards | Co-branded Credit Cards |
|-------------------------|-------------------------------------------|------------------------------|---------------------|--------------------|------------|--------------------------|-------------------------|
| Mean                    | 22.0%                                     | 44.6%                        | 37.3%               | 48.8%              | 40.7%      | 71.3%                    | 60.0%                   |
| St Deviation            | 4.2%                                      | 9.6%                         | 6.7%                | 8.5%               | 6.4%       | 6.4%                     | 7.6%                    |
| CoV                     | 19.2%                                     | 21.5%                        | 18.0%               | 17.4%              | 15.7%      | 8.9%                     | 12.7%                   |
| Rho                     | 2.1%                                      | 5.8%                         | 3.1%                | 4.5%               | 2.7%       | 3.2%                     | 3.7%                    |
| Balances (\$Bil) Dec-10 | 0.1                                       | 0.3                          | 0.4                 | 0.1                | 0.4        | 0.4                      | 0.3                     |

# Questions



American Express appreciates the opportunity to share additional data with the Agencies and would be happy to discuss further, at your convenience. If you have any questions at all, please do not hesitate to contact: Misha Dobrolioubov, Vice President - Risk & Information Management, at (212) 640-3687.

# Appendix: American Express Comment Letter



American Express  
200 Vesey Street  
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New York, NY 10285

October 22, 2012

*Via Electronic Delivery*

Department of the Treasury  
Office of the Comptroller of the Currency  
250 E Street, S.W.  
Washington, DC 20219

Federal Deposit Insurance Corporation  
550 17th Street, NW.  
Washington, DC 20551

Board of Governors of the Federal Reserve System  
20th Street & Constitution Ave., NW.  
Washington, DC 20551

Re: *Basel III Capital Proposals, Advanced Approaches  
RIN Nos. 1557-AD46, 3064-AD97, and 7100AD-87*

Ladies and Gentlemen:

American Express Company (“American Express”) appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System (together, the “Agencies”) in response to their three notices of proposed rulemaking that would substantially revise the regulatory capital framework for U.S. banking organizations.<sup>1</sup> In this letter, we offer our comments with respect to the treatment of charge and hybrid cards as qualifying revolving exposures (“QREs”) under the Advanced Approaches NPR.

<sup>1</sup> Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approaches for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,833 (Aug. 30, 2012); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Market Risk Capital Rule, 77 Fed. Reg. 52,973 (Aug. 30, 2012) (“Advanced Approaches NPR”).

RIN Nos. 1557-AD46, 3064-AD97, and 7100AD-87  
October 22, 2012

## I. Modification of the QRE Definition to Unambiguously Include Charge Cards

Under the current advanced approaches rules, credit card and other revolving credit exposures are classified as QREs, so long as the exposure is less than \$100,000. American Express believes that charge card exposures present more benign risk characteristics than credit cards and, therefore, should be subject to a lower capital charge, given the same risk inputs (e.g. probability of default, exposure at default and loss given default). However, the current rules provide for only three retail exposure categories: residential mortgages, QREs and "other retail." Retail exposures that are not residential mortgages and ineligible for QRE treatment are generally classified as "other retail" exposures. This generally results in substantially higher capital requirements than QREs. Recognizing the more benign risk characteristics of charge cards as compared to credit cards, the Agencies have proposed to clarify the QRE definition to ensure that qualifying charge card exposures would clearly be classified as QRE.

In the absence of an additional retail asset category that would more appropriately align economic risk and regulatory capital requirements, American Express strongly supports modifying the definition of QRE to unambiguously include qualifying charge card exposures. As the Agencies state in the preamble to the Advanced Approaches NPR, "charge cards are more closely aligned from a risk perspective with credit cards than with any type of 'other retail' exposure."<sup>2</sup> American Express agrees, and notes that when compared to credit cards, charge cards exhibit:

- **More favorable risk characteristics.** Unlike credit cards, traditional charge card balances must be paid in full within one month of billing, which reduces the risk of credit deterioration. Although charge cards ordinarily do not have a pre-set spending limit, American Express uses "real time" exposure management practices, including risk-based underwriting, to continuously and rigorously manage customer risk.
- **Lower loss rates.** Net write-off rates for American Express consumer and small business charge cards have generally been lower than write-off rates for consumer and small business credit cards, including during the recent recession. Lower write-off rates result from charge cards' reduced risk of credit deterioration, as discussed above.
- **Lower loss volatility.** Charge cards exhibit a lower loss rate coefficient of variation ("CoV"), as well as a lower asset-value correlation of loss, than credit cards.<sup>3</sup>

<sup>2</sup> Advanced Approaches NPR, 77 Fed. Reg. 52,994.

<sup>3</sup> CoV measures the volatility of losses in a specific class of exposures, normalized by the average level of losses. Asset correlation measures the extent to which losses in a specific class of exposures are correlated.



# Appendix: American Express Comment Letter



RIN Nos. 1557-AD46, 3064-AD97, and 7100AD-87  
October 22, 2012

In sum, the proposed changes more accurately reflect the underlying risk characteristics of charge cards as compared to credit cards, and therefore represent an appropriate modification to the definition of QRE.

## II. Technical Comments on the Definition of QRE

The Advanced Approaches NPR defines a QRE as an exposure (other than a securitization exposure or an equity exposure) to an individual that is managed as part of a segment of exposures with homogenous risk characteristics, not on an individual-exposure basis, and:

- (1) Is revolving (that is, the amount outstanding fluctuates, determined largely by a borrower's decision to borrow and repay, up to a pre-established maximum amount);
- (2) Is unsecured and unconditionally cancelable by the [BANK] to the fullest extent permitted by Federal law; and
- (3) Has a maximum contractual exposure amount (drawn plus undrawn) of up to \$100,000, or the [BANK] consistently imposes in practice an upper limit of \$100,000.<sup>4</sup>

American Express suggests the following modifications to this definition, in order to support the Agencies' efforts to expressly permit certain charge card products to qualify as QRE:

- (1) Is revolving (that is, the amount outstanding fluctuates, determined largely by a borrower's decision to borrow and, ***except for balances required to be paid in full every month, how much to repay***) up to a pre-established maximum amount;
- (2) Is unsecured and unconditionally cancelable by the [BANK] to the fullest extent permitted by Federal law; and
- (3) ***To meet the pre-established maximum amount requirement in clause (1), (a) Has a maximum contractual exposure amount (drawn plus undrawn) of up to \$100,000, or (b) the [BANK] consistently imposes in practice an upper limit of \$100,000 for products with a balance required to be paid in full every month, the total balance does not in practice exceed a maximum amount of \$100,000.***

First, it should be made explicit that clause (3) modifies the clause (1) requirement for qualifying exposures to revolve "up to a pre-established maximum amount." Therefore, we propose that the phrase "To meet the pre-established maximum amount requirement in clause (1)" be inserted before the phrase "Has a maximum contractual exposure amount (drawn plus undrawn) of up to \$100,000."

<sup>4</sup> Advanced Approaches NPR § \_\_.101, 77 Fed. Reg. 53,004-05 (emphasis added).

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Second, the phrase “the [BANK] consistently imposes in practice an upper limit of \$100,000” in clause (3) should be replaced with the phrase “for products with a balance required to be paid in full every month, the total balance does not in practice exceed a maximum amount of \$100,000.” Most charge cards do not have “bright line” upper limits on cardholders’ ability to charge. Instead, charge card exposures are limited through risk-based underwriting of each transaction and continuous, real-time customer monitoring and risk management. For example, rather than impose a “front end” upper limit on a cardholder’s ability to charge, American Express may define limited segments of charge card portfolios where the Cardmember’s balance is highly unlikely to exceed \$100,000 over the next 12 months. In the unlikely event that the balance on one of the charge cards in that segment does exceed \$100,000 during that period, that exposure would be classified as an “other retail” exposure for the next 12 months, and then re-evaluated for QRE eligibility at the end of that period. Segments of the charge card portfolio with balances that are not assessed as highly unlikely to exceed \$100,000, including of course balances that do exceed \$100,000, will be classified as “other retail.” In sum, our proposed modifications would more accurately capture the limits and controls used by American Express, which should be used to classify qualifying charge card customers as QREs.

Third, consumers may have limited discretion with regard to the amount repaid each cycle and the Agencies note that “[c]harge card exposures may be viewed as revolving in that there is an ability to borrow despite a requirement to pay in full.”<sup>5</sup> Therefore, the definition should be revised to reflect that, for revolving products that require balances to be paid in full every month, outstanding amounts would not be determined by a borrower’s decision how much to repay. American Express, therefore, proposes that clause (1) be modified to state that “...the amount outstanding fluctuates, determined largely by a borrower’s decision to borrow and, *except for balances required to be paid in full every month, how much to repay...*”

### III. Hybrid Cards as QREs

In the Advanced Approaches NPR, the Agencies request comment on whether “hybrid cards” exhibit similar risk characteristics to credit and charge cards, and whether the Agencies should permit them to qualify as QREs.<sup>6</sup>

As the Agencies note in the Advanced Approaches NPR, “hybrid” cards exhibit functional characteristics, such as payment features, of both credit and charge cards. While credit cards generally require that only a small portion of the outstanding balance be paid at the end of each billing cycle (typically 2 or 3 percent), many charge cards require that the entire balance be paid in full each cycle. Hybrid cards incorporate features of both credit and charge

<sup>5</sup> Advanced Approaches NPR, 77 Fed. Reg. 52,994.

<sup>6</sup> Advanced Approaches NPR, 77 Fed. Reg. 52,994.

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cards, and generally permit a cardholder to extend a portion of the card balance to revolve beyond one billing cycle.

American Express offers charge cards with a “Lending on Charge” feature that may be considered “hybrid” cards for purposes of the Advanced Approaches NPR (“Charge Cards with Lending On Charge”). American Express offers Charge Cards with Lending On Charge to consumers and small business customers with favorable risk characteristics. While typical charge cards require payment in full at the end of every month, Charge Cards with Lending On Charge permit a cardholder to extend payment on certain portions of the card balance.

American Express’ experience indicates that its Charge Cards with Lending On Charge exhibit risk characteristics similar to traditional charge and credit cards. The average historical loss rates of Charge Cards with Lending On Charge, as well as the volatility of loss rates measured by coefficient of variation and implied asset-value correlation, are comparable to those of charge and credit cards.<sup>7</sup>

Because Charge Cards with Lending On Charge exhibit risk characteristics comparable to both credit cards and charge cards without the Lending On Charge feature, American Express believes they should qualify for QRE treatment. The Agencies have indicated their intent to unambiguously align traditional QRE exposures with exposures that have similar risk characteristics, and this objective would be advanced by including Charge Cards with Lending On Charge in the definition of QRE.

American Express believes that if a hybrid card meets the definition of QRE, it should not be excluded simply because it is a hybrid card. As discussed, Charge Cards with Lending On Charge demonstrate functional and risk characteristics of both traditional charge and credit cards; the Agencies’ analysis of whether hybrid cards are QREs should therefore focus on whether the hybrid card meets the definition of QRE. Amending the definition of QRE in a manner consistent with our suggestions, will help to clarify that Charge Cards with Lending On Charge qualify as QREs.

\* \* \*

<sup>7</sup> The asset value correlation of losses for American Express consumer and small business credit and charge cards is lower than the 4 percent asset value correlation parameter applicable to QREs under the current advanced approaches rules.

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Thank you for considering our comment letter. We appreciate the opportunity to share our views with the Agencies and would be happy to discuss any of them further at your convenience. If we may be of further assistance, please contact us at (212) 640-2000.

Sincerely Yours,

A handwritten signature in black ink that reads "Daniel T. Henry".

Daniel T. Henry  
Chief Financial Officer  
American Express Company

A handwritten signature in black ink that reads "Ashwini Gupta".

Ashwini Gupta  
Chief Risk Officer  
American Express Company

cc: Ms. Juliana S. O'Reilly  
Managing & Chief Bank Regulatory Counsel  
American Express Company

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