



Risks Associated with the Sale of Charged off Debt

Facts

- Largest percentage of charged off debt flowing through the ARM industry is credit card debt.
- Largest number of complaints filed with the FTC concerns debt collection activities.
- Most of the complaints received by the FTC apply to collecting charged off credit card debt.
- The vast majority of Debt Collectors and Debt Buyers which are purchasing, collecting and/or selling credit card debt are not PCI Compliant. Data security in the industry would have difficulty meeting the FTC's "reasonable and appropriate" standard.

Risks/harms to the Issuer Brand

Significant **account integrity issues exist** in the marketplace once the debt is sold by the Issuer. As result, the following risks/harms to the Issuer brand are present today:

- Key data points which are required to maintain the integrity of an account are routinely lost or changed producing inaccuracies in charge off dates, last payment dates, date of first delinquency, etc. as the data flows downstream
- The balance which is currently being collected from the consumer is routinely challenged. Downstream collectors and debt buyers have difficulty explaining/reconciling/verifying/justifying balances, interest, late charges, and other allowable collection fees.
- Accounts are occasionally placed with multiple agencies (double placement) or sold to multiple debt buyers (double sales) simultaneously as a product of poor business practices or fraud causing consumer confusion and distrust.
- Consumers will dispute or settle a debt with a collection agency only to find it has been resold (sometimes years later) as an undisputed, fully collectible debt to a different debt buyer (a.k.a "Zombie debt").
- Collection attorneys are having difficulty in court establishing ownership of the account (giving them standing) and the balance to be collected.
- The FTC's primary concern regarding debt collection is the lack of data integrity (or more descriptive term would be account integrity) in the industry. In their recent recommendations, the FTC defined the following harms and consumer impacts:
 - Consumers do not have confidence the balance's being collected are accurate.



- Disputed balances are not adequately investigated and resolved. Rather they are passed onto the next debt buyer and/or collection agency working the account.
- Information on changes in status of an account including resolution of disputes is not being reported to the credit bureaus. As a result, an inaccurate picture of the credit profile of the consumer is being painted by the credit reporting agencies.

Impact to Issuer

Any harm which happens to the consumer when an Issuer branded account is involved harms the Issuer brand. Any activity which makes it more difficult to collect on past due/charged off accounts harms the payment card industry in general and the Issuer brand.



Regulatory Impact of Current Model on Issuers

Issuers face the following regulatory risk from the current process of buying, selling, and collecting debt.

GLBA Compliance Issues

Requirement: Scrutinize vendors (Debt Buyers) to ensure their current policies and practices take reasonable and appropriate protections of personal identification information.

Risk: While scrutiny is given of vendors, there are areas where additional scrutiny is required.

- Downstream sales of portfolios by debt buyers. Issuers currently review data security safeguards put in place by their debt buyers. However, this due diligence review is missing a critical security issue. The same Debt Buyers are not requiring like data security requirements on their downstream buyers or their servicers. The Issuer's due diligence must include a review of steps the debt buyer takes to ensure its servicers and its debt buyers are properly protecting this data. And, each downstream debt buyer needs to be required to do the same of its assigns and debt buyers. As a result, Issuer provided and branded data and documentation which contains personal identification information is flowing through the ARM Industry without adequate safeguards. This become even more important because of the Red Flags rule – see below.
- Sale of media to debt buyers. While the request for media (statements, applications, receipts, etc.) is originating from the first tier debt buyer, it is often being done on behalf of a downstream debt buyer which now owns the account. And, the downstream debt buyer has not been properly vetted for adequate protections for personal identification information. Again, Issuer provided and branded information is flowing through the industry without adequate safeguards.
- Downstream distribution of media. There are a couple of issues which need to be reviewed to ensure the Issuer is not facing risk of GLBA and FTC Act Section 5 violations.
 - Validation of media request at account level. When media is requested by the Issuer's buyer, there following question needs to be answered: Is the validation of the request conducted by the Issuer at the buyer level or at the account level?
 - Buyer level. This is a GLBA and FTC Act Section 5 violation because appropriate safeguards were not provided to ensure the Personal Identification Information was provided to the actual owner of the account. The Issuer may have sold the account to another debt buyer. And, no authoritative verification of the current ownership can be made.
 - Account Level. If the request is at the account level, processing the request may not be a GLBA and FTC Section 5 Act violation (see next bullet point).



- Validation of current ownership. Issuers do not and cannot verify the request for media is coming from the actual owner of the account. Rather, the only validation which is occurring is the debt buyer has purchased the account and, depending on the Issuer, the identified account was actually at one time sold to the requesting buyer.

If the account has been sold by the debt buyer, then providing media to this debt buyer appears to be a violation of GLBA and FTC Section 5 because it is no different than a third tier buyer making a request for media from the Issuer. And, Issuers do not provide media directly to the third tier buyer; only to first tier buyers to protect themselves from GLBA and FTC Section 5 violations.

The current practice of pass through of media without ownership validation does not provide the appropriate safeguards required to secure these transactions and as a result are a GLBA and FTC Section 5 Act violation. The FTC case to review is FTC v ChoicePoint.

Risk: Account data and media (i.e. consumer statements, applications, and receipts) which contain Personal Identification Information (PII) are being provided to third parties who do not have adequate data protection safeguards.

As debt is bought and sold, the distribution of media can pass through multiple debt buyers and servicers who do not own the account, do not have a business interest in the Personally Identifiable Information (PII), and have not taken reasonable and appropriate steps to protect the information.

Exposure: \$2500 per account

Example: Issuer sells 100,000 charged off accounts a month.

- \$250 million risk in GLBA sanctions per month.
- 20 years of FTC oversight of information security program

Note: There are other regulatory requirements for the protection of PII at the state level (over 40 states have PII protection laws including California's SB 1386). Failure to protect PII exposes the Issuers to fines at the state level, as well as potential fines from the payment card brands (PCI includes charged off accounts). These sanctions would be in addition to the GLBA exposure mentioned above.

FACTA Red Flags Rule Issue

Requirement: Identify areas of potential identity theft of consumer data and monitor for identity theft in those areas.

Risk: Monitoring of vendors for identity theft (debt buyers) is inadequate.

Exposure: Doubling of Fines under GLBA and 20 years of FTC oversight.



Sarbanes Oxley Issues

Requirement: Publicly traded entities are required to provide to shareholders information which accurately and with integrity reflects the organization's financial performance within each reporting period. This report should also disclose potential risk which is material to future performance.

Risk: Potential multi-billion dollar regulatory risk (as described in this document) impacting the largest Issuers has not been recognized and as a result the information has not been provided to Board of Directors for review. Further, it has not been presented to the audit committee for final determination as to whether the risk should be considered material and included in the Issuer's 10Q.

Exposure: Non-compliance penalties range from the loss of exchange listing, loss of D&O insurance, multi-million dollar fines, imprisonment to lack of investor confidence. A CEO or CFO who submits a wrong certification is subject to a fine up to \$1 million and imprisonment for up to ten years. If the wrong certification was submitted "willfully", then the fine can be increased up to \$5 million and the prison term can be increased up to twenty years.

Civil Litigation

Areas of concern: Debtor attorneys are suing Issuers for FDCPA, FCRA violations, and identity theft committed by downstream debt buyers and collection agencies.

Risk: Litigation which is initiated by consumers against downstream debt buyers will likely include an attempt to litigate against the Issuer of the debt instrument. It is easy to determine which financial institution issued the card. However, definitively identifying who currently owns the debt can be a problem.

Exposure: Tens of Millions of dollars in legal fees resulting from responding to complaints filed on behalf of consumers who believe they have been harmed by collection activities. The fastest growing area of litigation in the courts today is the seeking of judgments against debtors. In response, the consumer bar has become increasingly savvy as to the current business practices in the ARM Industry. As a result, debtor attorneys are having increasing success litigating against debt owners.

And, new FCRA Rules (see Federal Register, December 13, 2007) which will soon go into effect will likely spark litigation resulting from inaccurate or incomplete information reported to the credit bureaus. The failure to report updated account information will be considered the same as not reporting information.

NOTE: The same issues which are happening with credit card debt are happening with mortgage debt. There are a number of recent cases in the last 18 months where creditor attorneys have had claims dismissed because they could not prove ownership due to chain of title issues.