## I. PURPOSE

Examiners will review policies and procedures relating to loan delinquency monitoring and classification to evaluate the accuracy of reported delinquency, the reasonableness of the Allowance for Loan and Lease Losses balance and whether systems, procedures and controls are in place to identify and monitor collection problem loans.

## II. DEFINITIONS

### 1. Loan Classification Definitions

a. **Substandard:** Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the financial institution will sustain some loss if the deficiencies are not corrected.

b. **Doubtful:** Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

c. **Loss:** Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future.

d. There is a close relationship between classifications, and no classification category should be viewed as more important than the other. The collectibility aspect of Doubtful and Loss classifications makes their segregation of obvious importance. The function of the Substandard classification is to indicate those loans which are unduly risky and, if unimproved, may be a future hazard.

**A complete list of adversely classified loans is to be provided to management, either during or at the close of an examination.**

2. **Special Mention Assets**
   a. **Definition:** A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.
   b. **Use of Special Mention:** The Special Mention category is not to be used as a means of avoiding a clear decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, perhaps coupled with large size, create some reservations about the loan. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of such loans in Special Mention is not justified.
      i. Ordinarily, Special Mention credits have characteristics which corrective management action would remedy. Often weak origination and/or servicing policies are the cause for the Special Mention designation. Examiners should not misconstrue the fact that most Special Mention loans contain management correctable deficiencies to mean that loans involving merely technical exceptions belong in this category. However, instances may be encountered where technical exceptions are a factor in scheduling loans for Special Mention.
      ii. Careful identification of loans which properly belong in this category is important in determining the extent of risk in the loan portfolio and providing constructive criticism for management. While Special Mention Assets should not be combined with adversely classified assets, their total should be considered in the analysis of asset quality and management, as appropriate.
      iii. The nature of this category precludes inclusion of smaller lines of credit unless those loans are part of a large grouping listed for related reasons.
      iv. Comments on loans listed for Special Mention in the Report of Examination should be drafted in a fashion similar to those for adversely classified loans. There is no less of a requirement upon the examiner to record clearly the reasons why the loan is listed. The comments should be directed towards achieving correction of the deficiencies identified.

## III. PRIMARY REFERENCES / RELATED REGULATIONS

1. Michigan Credit Union Act:
   - **a.** Section 342(3)(i): Adopting policies
   - **b.** Section 342(4)(g): Establishing internal controls
   - **c.** Section 386: Establishment and maintenance of reserves
   - **d.** Section 421: Credit Committee
   - **e.** Section 423: Loan conditions
2. FFIEC Uniform Retail Credit Classification and Account Management Policy
3. Office of Credit Unions (OCU) Letter 2010-CU-01
4. NCUA Letter 03-CU-01: Loan Charge-off Guidance
5. Fair Debt Collection Practices Act

## IV. MINIMUM PROCEDURES

**1. Validate Reported Delinquency:** Determine if delinquency is reported accurately.

- **a.** Reconcile reported delinquency to servicer statements, Aires download, or other reliable sources. Ensure accurate interpretation of past due reports from servicers, as their methods/formats for reporting vary greatly.
- **b.** Determine if delinquency is calculated consistently with contract terms (which may vary between loan types).
- **c.** Evaluate loan charge off policies and practices:
  - **i.** Ascertain compliance with the MCUA.
  - **ii.** Evaluate the reasonableness of practices and timeliness of charge offs, including the effect on reported net charge offs ratios and delinquency ratios.
  - **iii.** Evaluate methodology for valuing repossessed collateral. This includes:
    1. Timely write-down to net realizable value (market value less costs to sell)
    2. Expensing of fees
    3. Bid process
    4. Independence of purchaser/realtor
- **d.** Ascertain whether **all** collection problem loans are being identified, tracked and classified appropriately. (e.g. other Watch List loans, loans to bankrupt borrowers etc.).

**e.** Determine the likelihood that errors in reported delinquency and charge off practices may have a material effect on the accuracy of the financial statements and/or a material negative effect on the overall level of risk.

**2. Evaluate Controls / Identification of Problem Loans:**

**a.** Non-Delinquent Problem loans: Verify controls are in place to identify and track other collection problem loans (regardless of delinquent status). Such loans should be classified and reserved for based on facts known, regardless of whether they are delinquent. Examples include:

- **i.** Poor Amortization: Review the method for identifying loans which may be current, but are not amortizing properly (due to extension(s), prior delinquency, or other reasons), as these often represent loans where full collectability is questionable.
- **ii.** Paid ahead loans: Paid ahead loans without recent activity may indicate high potential for future loss (e.g. deceased, insurance payout, or 'skip' borrowers).
- **iii.** Bankrupt Borrowers: Loans where borrowers have recently filed bankruptcy should be closely scrutinized to ensure on-going collectability has not been impaired.

**i.** Loan Classifications: Evaluate management's practices relative to identifying and continually monitoring loans which may pose significant risk. Sound management of a complex loan portfolio would include comprehensive and regular monitoring of such loans, including a classification methodology (e.g. classifying loans Substandard, Doubtful, or Loss) to quantify the overall level of risk in each loan segment, and the loan portfolio as a whole.

**ii.** The loan classifications should represent the level of risk and likewise the heightened level of additional monitoring to be applied for loans. Dependent upon the nature and degree of concern for each, individual loans or loan segments shall be considered in the ALLL evaluation and reserves included for all reasonably foreseeable losses.

**iii.** Examiners should review management's initial classifications and subsequent changes, for reasonableness and completeness.

3. **Exam Report:** Management shall be provided a list of all adversely classified assets at the close of each examination.
   - **a.** The list of loans should be reviewed during the examination contact with management.
   - **b.** The classification may be used to illustrate the overall level of risk in the loan portfolio, including changes in the overall level of risk from examination contact to examination contact.
   - **c.** The classification may be divided into categories deemed most appropriate by the examiner, to illustrate the risk in the balance sheet.
   - **d.** Narrative should be included, explaining the reason for the concern relative to each loan, with updates, and reserve amounts (if applicable).
   - **e.** Classification names used by the credit union may be used, if deemed reasonable and appropriate. Otherwise the categories of “Substandard”, “Doubtful”, “Loss” and “Special Mention” should be used.

**Refer to the attached Asset Classification Procedures for further guidance.**

## V. OTHER PROCEDURES TO PERFORM AS APPROPRIATE

1. Test the reasonableness of loan reserves by taking a previous ALLL evaluation and comparing the reserves with the actual disposition of those loans previously classified and/or reserved for.

2. Verify other controls are in place to prevent understatement of delinquency.
   - **a.** Controls over file maintenance must be adequate to prevent improper advancing of due dates.
     - **i.** This includes secondary review of file maintenance activity by persons without file maintenance capability to validate maintenance of loan terms (changes in due dates, payment amounts, interest owed etc.);
     - **ii.** Secondary review of file maintenance activity should include reporting mechanisms, and corrective action procedures, for file maintenance identified which is not supported by duly approved and executed loan agreements/modifications etc.
   - **b.** Controls to ensure sale of repossessed collateral does not advance due dates.

3. Verify internal controls surrounding the separation of loan approval, issuance, collections, and charge off authority.

4. Review a sample of loan histories (including some delinquent loans) to determine if payments are being applied according to contract terms.

5. Review late fee assessments, compared with the loan contract terms, and evaluate the legality/reasonableness of late fees assessed.

6. Test the Aires download to identify other loans with problematic characteristics, which may not be identified by the credit union. For example:
   a. Loans which do not appear to be amortizing properly;
   b. Loans with extraordinarily high accrued interest;
   c. Zero or low interest rates;
   d. Zero or very low payment amounts;
   e. Matured balloon notes;
   f. Loans with balances in excess of credit limits;
   g. Closed end loans where current balance exceeds original loan amount;

## VI. ATTACHMENTS / FORMS

1. 10350 A1: Asset Classification Procedures
2. 10350 A2: Sample Asset Classification Summary
3. 10350 A3: Sample Asset Classification Template