ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

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SUBJECT: Classification Guidelines for Repossessions and Credit Card Debt

BACKGROUND

The Bank Department has revised its classification policies regarding repossessed personal property and credit card debt. State banks should modify their internal policies and procedures, if necessary, to ensure compliance with this policy. Exceptions are permissible when extenuating circumstances exist.

POLICY

Repossessions

All repossessed automobiles, motorcycles, small boats, and all terrain vehicles (3/4 wheelers) will be adversely classified as follows:

Held 0 - 90 days: **Substandard**
Held over 90 days: **Loss**

For repossessed assets not identified above (i.e. agriculture equipment, large boats, logging equipment, etc.) banks must comply with Arkansas Code Annotated §23-47-507, which states:

> "A state bank may hold and sell all kinds of property that may come into its possession as collateral security for loans or any ordinary collection of debts in the manner provided by law. Any personal property coming into its possession in this manner and which is not otherwise authorized for state banks to own as an asset shall be disposed of as soon as possible and after twelve (12) months from the date of acquisition shall cease to be considered as a part of its assets."

Examiner discretion will determine appropriate classifications for other types of personal property (i.e. fixtures, retail inventory, etc.). All repossessed assets must be recorded at the lower of the remaining loan amount or fair value of the assets received.

<u>Credit Card Debt</u>

Credit card debt will be adversely classified in accordance with the Federal Financial Institutions Examination Council (FFIEC) Uniform Retail Credit Classification and Account Management Policy ("Retail Classification Policy") which establishes standards for the classification and treatment of retail credit by financial institutions. Based on the volume of accounts in the portfolio and on the relative small size of the loans on an individual basis, credit card loans are classified using methods that are different than those normally used for traditional types of credit, such as commercial loans or agricultural loans. But, similar to other types of credit, adversely classified credit card assets are allocated by risk to three categories: Substandard, Doubtful, and Loss.

Delinquency Thresholds

Repayment performance of individual borrowers traditionally is the best indicator of credit card loan quality. Therefore, credit card loans, at a minimum, are generally classified based on the following criteria from the Retail Classification Policy:

- Open-end and closed-end credit card loans that are past due **90** or more cumulative days from the contractual due date are classified **Substandard**.
- Closed-end credit card loans that become past due **120** cumulative days and open-end credit card loans that become past due **180** cumulative days from the contractual due date are classified **Loss** and charged off.

Accounts in bankruptcy should be classified Loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the timeframes specified in the Retail Classification Policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified Substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months. Fraudulent loans should be classified Loss and charged off no later than 90 days of discovery or within the timeframes specified in the Retail Classification Policy, whichever is shorter. Accounts of deceased customers should be classified Loss and charged off when loss is determined or within the timeframes specified in the Retail Classification Policy, whichever is shorter.

If a bank can clearly document that a past due credit card loan is well-secured and in the process of collection, such that collection will occur regardless of delinquency status, then, according to the Retail Classification Policy, the credit card loan does not need to be adversely classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property that has an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

Examiner Discretion

The Retail Classification Policy does not preclude examiners from classifying individual retail credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient. Regardless of the classification methodology used, examiners must adequately assess and document the risk supporting the classifications. The examiner discretion method typically involves portfolio analysis. Common predictive indicators reviewed as part of portfolio analysis and that sometimes result in adverse classifications include, but are not limited to, over-limit loans, delinquencies, and score distributions.

- *Over-limit loans* – Loans that are over-limit, whether current or delinquent, may be, but are not necessarily, subject to adverse classification. Because over-limit practices vary from bank to bank and because the types of credit card programs vary from bank to bank, comparison of over-limit ratios from bank to bank is generally not the determining factor in assigning adverse classifications. Rather, a more fitting method of evaluating over-limit accounts for adverse classification lies in determining the trend and characteristics of over-limit accounts within the bank under review. Consideration is given to the make-up and reasons for the volume of over-limit credit card receivables/accounts as well as trends in performance of the over-limit receivables/accounts. For example, if all or a certain segment of over-limit loans (for example, chronic over-limit loans) are shown to typically move to charge-off, adverse classification should be considered.

- *Delinquencies* – Loans overdue, but overdue to a lesser degree than the specified delinquency thresholds, may be, but are not necessarily, subject to adverse classification. Examiners should review the delinquency trends in certain higher-risk portfolios or categories of loans to determine if those pools warrant adverse classification, even if delinquency is below the specified thresholds, keeping in mind any distortion resulting from seasonal influences, economic conditions, or the timing of examinations and keeping in mind the type of program that the bank offers. Examiners should carefully consider the makeup and reasons for the volume of overdue credit card loans. For example, subprime portfolios typically reflect higher delinquency levels than prime portfolios, but that in and off itself may not be reason to adversely classify a subprime portfolio. If migration analysis reflects that substantially all of a certain segment of loans eventually flows to charge-off (regardless of whether the overall volume of delinquencies is of concern), it may be appropriate to classify that segment of loans. Some loans that evidence frequent delinquency histories within a recent period but that may now be current can also be considered for adverse classification in certain situations.

- *Scores* – Pools of loans within certain score ranges may be, but are not necessarily, subject to adverse classification. Select pools of receivables sometimes reflect increased (and undue) risk based on the cardholder credit scores, behavior scores, or other types of scores. For example, as part of management's segmentation methods, a report might show that accounts of cardholders within certain credit score ranges might evidence a much higher propensity to roll to loss than the remainder of the portfolio. Those accounts could be considered for adverse classification if the propensity is regarded as substantial enough to warrant adverse classification.

These factors (over-limit accounts, delinquencies, and score distributions) are just a few examples of the types of characteristics that could lead to adverse classification of the associated loan pools when circumstances warrant. Common sense and judgment are critical in determining the extent of adverse classifications, and management's segmentation reports are often a good starting point to identify any segments that might be evidencing higher risk and, therefore, may need to be considered for adverse classification. In addition to portfolio analysis, the account-level reviews conducted during the examination may aid the examiner in assigning adverse classifications. The reviews may reveal concerns which could lead to certain portfolios, or segments thereof, being adversely classified. For example, if the account-level review shows that the bank has been improperly moving accounts from one workout program to another to delay losses, the pool of workout accounts, or a certain segment thereof, may warrant adverse classification, even if the loans do not meet the specified delinquency thresholds.

Subprime Credit Card Loans

Subprime lenders should recognize the heightened loss characteristics in their portfolios and should, therefore, internally classify delinquent accounts well before the timeframes specified in the Retail Classification Policy. Adverse classification considerations are extremely critical for subprime lending programs, and examiner discretion is most often the preferred method of determining classifications for these types of high-risk portfolios. While subprime loans fall under the umbrella of the Retail Classification Policy, standards within that policy are considered minimums, and expanded or more severe classifications for the subprime portfolio may be warranted.

Examiners should not automatically adversely classify or Special Mention credit card loans merely because they are considered subprime. Subprime credit card loans that are past due 90 days or more should be classified at least Substandard based on a reasonable presumption that the past due status is indicative of inadequate capacity and/or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience, or other risk indicators, of the particular portfolio or segment thereof. When portfolio review or transaction testing indicates serious concerns with credit risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire subprime portfolio or segments thereof. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems.

Special Mention

A Special Mention asset has potential weaknesses that deserve management's close attention and that, if left uncorrected, might result in deterioration of the repayment prospects for the asset or in the bank's credit position at some future date. The nature of this category precludes inclusion of smaller lines of credit, such as credit card loans, unless those loans are part of a large grouping listed for related reasons. Special Mention assets are not adversely classified and do not expose a bank to a high enough level of risk to warrant adverse classification. Nevertheless, careful identification of loans (or portfolios) that properly belong in this category is important in determining the extent of risk in the aggregate loan population and providing constructive criticism to 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.

Summary of Examination Goals – Adverse Classifications

To quantify and communicate the results of the card portfolio and lending appraisals, the examiner decides which credit card related assets will be subject to criticism and/or comment in the examination report. When deciding which credit card loans will be subject to criticism and/or comment in the examination report, examiners use the Retail Classification Policy and examiner discretion.

Assigning adverse classifications usually involves:

- Reviewing past due reports to identify loans subject to adverse classification based on the delinquency thresholds in the Retail Classification Policy.
- Reviewing management's internal classification methodologies (which may include a review of allowance methodologies to see what accounts, portfolios, or portfolio segments management considers as high-risk).
- Reviewing classification methodologies used in prior examinations and determining whether they remain appropriate or require adjustment. This may include assessing policy and procedure changes made since the last examination.
- Reviewing management reports, including those available on a segmented basis, to identify portfolios or portfolio segments that may warrant adverse classification.
- Reviewing results of transaction testing to identify any loan pools that warrant adverse classification.
- Developing classification volumes (ensuring use of mutually exclusive figures) and write-ups.
- Discussing the classification methods used with the EIC and providing documentation thereof to the EIC.
- Discussing classifications with management.

REFERENCES

- Arkansas Code Annotated §23-47-507 – Power to Hold and Sell Collateral
- FFIEC Uniform Retail Credit Classification and Account Management Policy
- FDIC Credit Card Activities Manual
- Board of Governors of the Federal Reserve System Commercial Bank Examination Manual – Section 2130 - Consumer Credit