2002

DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION

DIVISION OF BANKING

BUREAU OF BANKS AND TRUST COMPANIES

COMMERCIAL BANKING

SPECIAL MENTION AND ADVERSE CLASSIFICATION GUIDELINES

Commercial Loans, Leases, Commercial Real Estate Loans And Off Balance Sheet Items

All commercial loans, leases, commercial real estate loans and off balance sheet items should be evaluated on an individual basis. Each item must meet the following definitions to be listed for Special Mention or adverse classification.

Special Mention

The Special Mention category should not be used solely to identify items where credit data exceptions or collateral documentation deficiencies are not material to repayment. The definition of Special Mention is as follows:

A Special Mention item 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 item or in the institution's credit position at some future date. Special Mention items are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

The following principles apply to assets and items listed as Special Mention.

- Classified items, which by definition do not include Special Mention items, will be the standard measure used in expressing the quality of a bank's loan portfolio and other assets. The agency will not express asset quality in terms of "criticized assets," a term that is generally recognized as including both Special Mention and classified assets.

- Special Mention items will not be combined with classified items in examination reports or corporate applications.

- Internal monitoring will not require banks to report criticized items totals or percentages. However, examiners will continue to consider the level and trend of items listed as Special Mention in their analysis as appropriate.

- When implementing standards for safety and soundness, the agency will use classified items and not use criticized items as a measure of asset quality.

Substandard

Items classified substandard are inadequately protected by either the current sound worth, the paying capacity of the obligor or the collateral pledged, and possess a degree of risk which is deemed inappropriate. Items so classified have a well-defined weakness or weaknesses that either jeopardize their liquidation or create an inappropriate risk. There is a distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful

Items classified doubtful have all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, highly questionable and improbable based on currently existing facts, conditions, and values.

Loss

Items classified loss are considered uncollectible and of such little value that their continuance as bankable items is not warranted, or they are considered of such nature that their existence has created a definite potential for loss. This classification does not mean that the items have absolutely no recovery or salvage value. It is not practical or desirable to defer writing off these items even though partial recovery may be effected in the future.

Consumer and Residential Real Estate Loans

On February 10, 1999, the Federal Financial Institution Examination Council ("FFIEC") issued in the Federal Register the Uniform Retail Credit Classification and Account Management Policy. This policy statement updates and expands the former Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status issued in 1980. The Uniform Retail Credit Classification and Account Management Policy establishes uniform classification and treatment of retail credit and residential real estate loans; establishes uniform charge-off criteria for bankrupt obligors, deceased obligors, and fraudulent accounts; establishes limits on re-aging, extending, deferring or rewriting past due accounts; and broadens how a partial payment can qualify as a full payment. Subsequently, the FFIEC revised the Uniform Retail Credit Classification and Account Management Policy on June 6, 2000 to clarify various items with respect to (1) the re-aging of open-end accounts; (2) extensions, deferrals, renewals, and rewrites of closed-end loans; (3) examiner considerations; and (4) the treatments of specific categories of retail loans. The effective date for the implementation of the changes in the revised policy statement was deferred to the December 31, 2000 Call Report.

The Division of Banking, Bureau of Banks and Trust Companies is adopting the revised Uniform Retail Credit Classification and Account Management Policy (refer to Attachment #1) and will apply it to all state banks and their operating subsidiaries.

[Revised: October, 2005]

Attachment 1

Uniform Retail Credit Classification and Account Management Policy[1]

The Uniform Retail Credit Classification and Account Management Policy establishes standards for the classification and treatment of retail credit in financial institutions. Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home improvement loans. Because a retail credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

- Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified Substandard.

- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified Loss and charged off.[2] In lieu of charging off the entire loan balance, loans with non-real estate collateral may be written down to the

[1] The agencies' classifications used for retail credit are Substandard, Doubtful, and Loss. These are defined as follows: Substandard: An asset classified Substandard is protected inadequately by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Assets 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 institution will sustain some loss if the deficiencies are not corrected. Doubtful: An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Loss: An asset, or portion thereof, classified Loss is considered uncollectible, and of such little value that its continuance on the books is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value; rather, it is not practical or desirable to defer writing off an essentially worthless asset (or portion thereof), even though partial recovery may occur in the future. Although the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision do not require institutions to adopt identical classification definitions, institutions should classify their assets using a system that can be easily reconciled with the regulatory classification system.

[2] For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate. OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified Loss in lieu of charge-offs. Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

value of the collateral, less cost to sell, if repossession of collateral is assured and in process.

- One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios greater than 60 percent should be classified Substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified.

- However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified Substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent. For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified Loss and charged off.

- Loans 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 time frames specified in this 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 time frames adopted in this classification policy, whichever is shorter.

- Loans of deceased persons should be classified Loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

Other Considerations for Classification

If an institution can clearly document that a past due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with 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.

Partial Payments on Open-and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, the loan would be $900 ($150 shortage times six payments), or three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

Re-Aging, Extensions, Deferrals, Renewals, and Rewrites[3]

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

---

[3] These terms are defined as follows. Reage: Returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that are contractually due. Extension: Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. Deferral: Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, of the loan. The account is shown current upon granting the deferral. Renewal: underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. Rewrite: Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

- The borrower has demonstrated a renewed willingness and ability to repay the loan.

- The account has existed for at least nine months.

- The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an overlimit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once in twelve-months/twice in five-year limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Classification and Account Management 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.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk and account management systems, including a prudent retail credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

Implementation

This policy should be fully implemented for reporting in the December 31, 2000 Call Report or Thrift Financial Report, as appropriate.

Dated: June 6, 2000.