XI. 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. 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.

The three adverse classification categories are expressions of different degrees of a common factor, risk of nonpayment. All credit card loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound credit card loans. The practice of appropriately lending to financially sound businesses or individuals for reasonable periods via credit card loans is a legitimate banking function. As such, adverse classifications of credit card loans should be confined to those loans which unduly put the investment of depositors' funds at risk. To determine which credit card loans fit this description, examiners must consider guidelines within the Retail Classification Policy. That guidance governs the evaluation of small-denomination consumer loans, which include credit card loans. In addition to establishing general classification thresholds based on delinquency, the Retail Classification Policy grants examiners the discretion to classify individual loans as well as portfolios or portfolio segments that exhibit signs of credit weakness regardless of delinquency status.

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 loans that become past due 180 cumulative days from the contractual due date are classified Loss and charged-off.

The Charge-Offs section of the Portfolio Management chapter discusses losses and includes the Retail Classification Policy’s criteria for charging-off accounts such as those for bankrupt or deceased cardholders. Its fraud section talks about fraudulent accounts.

According to the January 31, 2001 *Expanded Guidance for Evaluating Subprime Lending Programs*, 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. Additional considerations for subprime loans, including those that are collateral dependent, are discussed later in this chapter.

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 generally 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

While the Retail Classification Policy provides minimum guidelines for adverse classifications based on delinquency thresholds, it does not preclude examiners from classifying credit card loans that exhibit other signs of credit weakness. Thus, examiners may also consider adversely classifying certain current loans and certain other delinquent loans. An examiner may classify credit card portfolios, or segments thereof, where underwriting standards, risk management practices, account management practices, or other controls are weak and present an excessive level of credit risk. Regardless of the classification methodology used, examiners must adequately assess and document the risk supporting the classifications.

Proper determination of adverse classifications requires examiners to acquire certain fundamental information about the credit card portfolios, borrowers' financial conditions, prospects for orderly debt repayment, and available collateral. Acquiring the information varies with the size of the bank and the portfolio types as well as with the type and sophistication of available records and reports.

Usually the examiner discretion method 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 (as discussed in the Transaction Testing chapter) 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 Loans:

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.

The *Expanded Guidance for Evaluating Subprime Lending Programs* specifically addresses classification guidelines for subprime lending. 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.

Mutually Exclusive Figures:

When determining adverse classifications, examiners must be careful to ensure that the volumes used for classification purposes are based on mutually exclusive figures so as to avoid double-counting. For example, if it is determined that all chronic over-limit balances should be adversely classified, examiners should be careful to only include those chronic over-limit balances that have not already been included in another adversely classified pool of receivables (for example, in a delinquency threshold pool). The process of whittling down the portfolio into mutually exclusive figures is necessary to accurately reflect risk in the card portfolio.

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.