Classification of Assets

An analysis of a savings association's asset quality is essential to the proper evaluation of its financial condition, viability, and ultimately, the risk it poses to the Federal Deposit Insurance Fund. The Office of Thrift Supervision (OTS) uses an asset risk rating system, commonly termed asset classification, to identify and monitor portfolio risk.

OTS regulation 12 CFR § 560.160, Asset Classification, requires each savings association to:

- Evaluate and classify its assets on a regular basis in a manner consistent with, or reconcilable to, the classification system used by OTS.
- Establish adequate general valuation allowances for classified assets.
- Charge-off or establish specific valuation allowances for assets classified as Loss.

LINKS

Program

Appendix A

The rule also states that a savings association's allowance policies must be consistent with generally accepted accounting principles and the practices of the federal banking agencies.

Regulatory Classification Ratings

The asset classification system used by OTS and the other federal banking agencies is the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks. Originally issued in 1938, the current classification system was revised in 2004. Elements of the Uniform Agreement were also incorporated into the Interagency Uniform Retail Credit Classification and Account Management Policy in 2000. (See CEO Letter 128.)

Both regulators and institutions use the classification system to evaluate the level of credit risk in loan portfolios, benchmark credit risk across institutions, and assess the adequacy of an institution's capital and allowance for loan and lease losses (ALLL).

Using a risk-based approach, you should perform an overall risk-based assessment of a savings association's loan and investment portfolios and select a representative number of assets for review and analyze those assets to determine credit quality. Each asset or group of assets reviewed is assigned a quality rating based on your best judgment of the likelihood of repayment or, if a loan is troubled, the likelihood of timely and orderly liquidation without loss of either principal or interest. Asset quality ratings are divided into three groups as defined below:

- Pass (not classified)
- Special Mention (a watch rating)
- Classified (an adverse rating).

Pass: Pass assets are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral in a timely manner.

Special Mention: 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.

Assets that could be included in the Special Mention category include those that have developed minor credit weaknesses since origination as well as those that were originated with such weaknesses. This includes loans the institution is unable to properly supervise because of an inadequate loan agreement, inadequate control over collateral (when such control is necessary to effect full repayment of the loan), or when a loan is made with significant deviations from prudent lending practices. An adverse trend in the obligor's operations or the obligor's highly leveraged balance sheet may warrant a Special Mention designation, provided that neither condition has deteriorated to the point that timely repayment is jeopardized. If timely payment is jeopardized, an adverse classification may be warranted.

Special Mention should not be used to identify an asset that has as its sole weakness credit data exceptions or collateral documentation exceptions that are not material to the timely repayment of the asset. For example, the failure of an institution to obtain current borrower financial statements on a performing loan does not, by itself, indicate a weakness in the loan and should not be cause for the loan to be automatically designated Special Mention. There may be cases, however, where borrowers fail to provide updated financial statements because they are reluctant to disclose their poor operating performance, which could justify a Special Mention designation or adverse classification. For large dollar loans, where the decision as to whether to classify the loan is heavily dependent on the borrower's (or property's) cash flows, you should have the institution obtain current financial statements during the examination or initiate other verification measures.

You should not designate as Special Mention a performing construction loan merely because the institution has failed to inspect construction in progress. The lack of such inspections is a deficiency in the institution's loan administration function that should be corrected but does not (by itself) indicate a weakness in the loan that would result in deterioration of the repayment prospects.

Finally, the Special Mention designation should not include loans listed merely "for the record," such as when uncertainties and complexities, coupled with a large loan amount, create reservations about the quality of the loan. Neither you nor savings association management are expected to identify all loans that will become troubled at some future date. If weaknesses cannot be identified, you should not include the asset as Special Mention.

To determine the extent of risk in the portfolio and to provide constructive feedback to management, it is important that you carefully identify assets that properly belong in this category. Generally, Special Mention assets are not individually detailed in the report of examination (ROE). When Special Mention assets are detailed in the ROE, however, the loans should be written up in a manner similar to that used for adversely classified assets found later in this Section.

You should not combine Special Mention assets with classified assets in the ROE or other reports. As appropriate, however, you should continue to consider the level and trends of Special Mention assets in your analysis of the institution's overall asset quality.

ADVERSE CLASSIFICATIONS

A savings association's level and trend of **adversely** classified assets is a strong indicator of its asset quality and management's ability to implement sound operating policies and procedures and control risk.

The three adverse classifications are **Substandard, Doubtful, and Loss**, as defined below.

> **Substandard**: A "substandard" asset is inadequately protected by the current sound 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.

Assets classified Substandard may be characterized by one or a combination of the following weaknesses:

- The asset is (or was) a loan or an investment that is nonperforming or nonearning. This includes REO[1] and nonperforming loans and investments, including residual tranches of securities that are on nonaccrual status.

- The primary source of repayment is severely impaired or gone and the institution may have to rely upon the secondary source.

- A loss may not seem likely, but sufficient problems have arisen to cause the association to go to extraordinary lengths to protect its position in order to maintain a high probability of repayment.

- The obligors are unable to generate enough cash flow to reduce their debts.

[1] Examiners and staff receive many questions about whether REO should be classified because it is carried at fair value. REO should be classified because it is a non-earning asset and must be continually evaluated for additional losses.

- There is a material deterioration in collateral value (if the collateral is expected to be a primary source of repayment).

- Flaws in the security agreement or lien documentation leave the association in a subordinated or unsecured position when the collateral is likely to be needed for the repayment of the loan.

The presence of one or more of these factors does not require that the asset be adversely classified if you determine that it is probable that the asset will be fully liquidated in a timely manner without loss of either principal or interest. Initiating a foreclosure or repossession of collateral will seldom result in a timely liquidation and does not meet such a requirement.

> **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 highly questionable and improbable on the basis of currently known facts, conditions, and values.

The likelihood of a loss on an asset or portion of an asset classified Doubtful is high. Its classification as Loss is not appropriate, however, because pending events are expected to materially affect the amount of loss. The Doubtful classification should not be used to defer the full recognition of an expected loss. Management should attempt to identify, then recognize, losses in a timely manner.

> **Loss:** An asset or portion thereof, classified Loss is considered uncollectible and of such little value that its continuance on the institution's books as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has no recovery or salvage value; but rather, there is much doubt about whether, how much, or when the recovery will occur. As such, it is not practical or desirable to defer the write-off.

An asset may be subject to a "split classification," where two or more portions of the same asset are given separate classifications. For example, assume an association has an unsecured loan to a company in liquidation. The bankruptcy trustee has indicated a minimum disbursement of 40 percent and a maximum disbursement of 65 percent to unsecured creditors. In this situation, estimates are based on liquidation value appraisals with asset values yet to be realized. A proper classification would show 40 percent Substandard, 25 percent Doubtful, and 35 percent Loss. (Refer to Examination Handbook Section 261, Adequacy of Valuation Allowances.)

> **Impairment and cost to sell:** When an asset is deemed impaired under generally accepted accounting principles, the asset is written down to fair value[2] less cost to sell, and reevaluated quarterly. In those cases, the loan amount in excess of fair value less cost to sell is classified Loss, and the remaining balance after charge-off is classified Substandard. However, if the repayment or satisfaction of the loan is dependent only on the operation, rather than the sale, of the collateral, the measure of impairment would not incorporate estimated costs to sell the collateral.

[2] As currently defined under GAAP, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

SELF-CLASSIFICATION

As cited above, pursuant to 12 CFR § 560.160, savings associations must evaluate the risks in their loan and investment portfolios, classify their assets and establish appropriate valuation allowances. In addition to evaluating loan and portfolio risk and identifying inherent asset quality problems, savings associations should use the classification system to identify strengths and weaknesses inherent in their lending and investment policies, standards, and practices. Classification trends can reveal lending patterns or deficiencies in portfolio administration that consistently result in collection problems or losses. Once the institution identifies such patterns or deficiencies, management and the board of directors should reevaluate its lending and investment programs and underwriting standards and structure them to avoid practices that result in a higher level of classified assets. In this way, the classification process can enable management to evaluate the effectiveness of policies and procedures and improve asset quality.

Savings associations are not required to use the same classification ratings for internal use as discussed above; however, internal ratings should correlate to the regulatory classification definitions. This will facilitate examiner review, analysis, and reporting.

The independence of internal asset review is important. The ultimate evaluation and classification of a loan should not rest with the loan officer or loan origination department. Loan officers and loan origination personnel may initially evaluate asset quality and classify loans within their department. Experience has shown, however, that internal asset quality reviews are often more realistic when evaluated by an independent internal asset review department or internal auditors. A small savings association may find it impracticable to have a dedicated internal asset review (IAR) department; if so it is recommended that loan be reviewed by the association's internal auditor or a third party that specializes in asset quality reviews.

An institution, through its IAR function, should perform a thorough analysis for each large credit. It should also segregate problem and potential problem loans by asset type and origination facility, and provide a comprehensive analysis of asset quality trends.

In institutions with an effective IAR department, you should focus your initial review on the work performed by that department. Review internally prepared credit quality analyses to determine whether you concur with the institution's scope and depth of reviews and assigned risk ratings. For non-homogeneous loans, focus on loans internally classified, those classified during prior examinations, large credits (including those that have not been assigned an adverse or Special Mention classification), high risk loans, and new loan types.

Your primary focus in the asset quality review is to ensure that the institution is appropriately classifying its assets and takes timely corrective actions for any weaknesses in its internal classification system. A well-organized, competent, and independent IAR department that incorporates a self-classification process will facilitate your review and enable you to spend less time on loan reviews and asset classifications.

Your classifications should closely parallel those of the savings association. Where they do not, you should carefully review the association's self-classification procedures to determine the reasons for the disparity. There may be good reason for a disparity in ratings. For example, the credit may have deteriorated since its last internal review. Conversely, the disparity could be from weakness in the institution's self classification system, such as inadequate scope, frequency or depth of review or a lack of independence. Any material divergence between your classifications and the institution's classifications raises questions as to the integrity of the institution's classification system. You must identify such disparities in the ROE and resolve them with senior management.

OTS relies on classification and delinquency data provided in the Thrift Financial Reports (TFR) to monitor a savings association's asset quality between examinations. Therefore, the reliability of this data is necessary to the proper supervision of savings associations and assessment of industry conditions.. As indicated in § 560.160, if you classify an asset during an examination that is different than the institution's classification, the institution must use that classification in reports to OTS until a change occurs in the asset that affects the basis for the classification. Management should periodically update these and all classifications, based on any improvement or deterioration that occurs. Therefore, it is important that institutions realistically and accurately classify their assets between examinations consistent with examiner classifications.

If you determine that an institution upgrades classifications without genuine improvement in the prospects for repayment or liquidation of the asset, the Regional Director may direct the institution to refrain from further upgrades of examiner classifications unless the asset classified has been liquidated or the institution receives prior approval of the OTS to upgrade a classification.

Classification Considerations

You should consider the following standards when you review specific asset portfolios. (Refer to individual asset quality Sections of this Handbook for more detailed analysis considerations.)

Commercial Loans

In the analysis of commercial loans for classification purposes, the institution should consider the:

- Purpose of the loan and the risk inherent in the project.
- Nature and degree of collateral security.
- Appropriateness of the payment and amortization structure for the borrower and credit facility.
- Loan covenants and borrower compliance with them.
- Character, capacity, and financial responsibility of the borrower.
- Performance record of the borrower for the loan under review as well as its other obligations.
- Feasibility and probability of a timely and orderly repayment of the loan in accordance with its specified terms.

The willingness and ability of a debtor to perform as agreed is the primary measure of the risk of the loan. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and reduce or liquidate principal as agreed in accordance with the terms of the contract. It does not mean, however, that borrowers must at all times be in a position to liquidate their loans.

Commercial real estate loans are often primarily dependent on the cash flows of the underlying security property to meet scheduled debt service. You should analyze historical and projected cash flows and underlying assumptions of the cash flow projections to determine if there is sufficient debt service coverage (the net cash flows of the property divided by the required debt service). Debt service coverage ratios (DSCR) should be in line with prudent industry standards.

You should also evaluate secondary sources of repayment, if any, such as financially responsible guarantors or endorsers for their ability and willingness to provide debt service in the event that the primary obligor is unable to perform in accordance with the terms of the loan agreement. Review the guarantor's current financial information and past payment history and judge whether orderly repayment of the debt through a secondary source would continue in the event of default by the primary obligor. Also, consider the association's track record. Has it been able to successfully collect on such guarantees or endorsements in the past?

Loans that an association has restructured are neither automatically classified nor exempt from classification. The credit must be analyzed in the same manner as other loans to determine the risk of nonpayment. If, however, the restructured loan is deemed to be a troubled debt restructuring in accordance with GAAP, an appropriate write-down of the loan must be recorded at that time with an offsetting entry to the ALLL. (Refer to Examination Handbook Section 240, Troubled Debt Restructurings.)

Commercial real estate loans that are adequately protected by the current net worth and debt service capacity of the borrower or guarantor are generally not classified. Similarly, loans to sound borrowers that are renewed or refinanced in accordance with prudent underwriting standards to creditworthy commercial borrowers are not classified unless well-defined weaknesses exist that jeopardize repayment. Collateral value alone should generally not be used to support a Pass or Special Mention classification on a loan where the borrower does not have the willingness or ability to repay the loan.

In evaluating commercial real estate credits for possible classification, you should apply the standard classification definitions described at the beginning of this section. In determining the appropriate classification, you should consider all important information on repayment prospects, including:

- Information on the borrower's creditworthiness and cash flows.
- The value and cash flow provided by all collateral that supports the loan.
- Support provided by financially responsible guarantors.

The loan record of performance to date is important and should be considered. You should not automatically classify or charge off a performing commercial real estate loan solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. It would be appropriate, however, to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

These principles hold for individual loans, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each loan should be based on the fundamental characteristics that affect the collectibility of the particular loan. The problems broadly associated with certain segments of an industry should not lead to overly pessimistic assessments of individual loans that are not affected by the problems of the troubled sectors.

You should not criticize an institution for continuing to hold loans with weaknesses that result in classification as long as it has a well-designed and effective workout plan and effective risk management and internal controls to manage these loans. See CEO Ltr 325 - Guidance on Prudent Commercial Real Estate Loan Workouts and Examination Handbook Section 340, Internal Controls.

Valuation and Classification of Troubled, Collateral-Dependent Loans[3]

A troubled, collateral-dependent loan is one in which proceeds for repayment can be expected to come only from the operation or sale of the collateral. OTS's policy for these loans is as follows:

- When, based on current information and events, it is probable that the lender will be unable to collect all amounts due (both principal and interest), the amount classified Loss should be no less than any excess of the recorded investment in the loan over the fair value of the collateral less cost to sell. The remainder should generally be classified Substandard.

Note: It is probable that the lender will be unable to collect all amounts due when the expected future cash flows, from the operation and sale of the collateral are less than the principal and interest payments due according to the contractual terms of the loan agreement. The term "all amounts due" is based on the original contractual terms, except as discussed below. The institution must calculate the expected cash flows from the operation and sale of the collateral on an undiscounted basis over a period of no more than five years.

- When it is probable, but not reasonably assured, that the lender will be able to collect all amounts due (both principal and interest), the amount classified Doubtful should be no less than any excess of the recorded investment in the loan over the fair value of the collateral less cost to sell. The remainder should generally be classified Substandard.

Note: It is deemed probable, but not reasonably assured, that the lender will be able to collect all amounts due when the expected future cash flows are equal to or greater than the principal and interest payments due according to the contractual terms of the loan agreement. Once again, the institution must calculate the expected cash flows from the operation and sale of the collateral on an undiscounted basis over a period of no more than five years.

[3] The policy described in this Section does not apply to smaller-balance homogeneous loans (such as one- to four-family owner-occupied home mortgage loans) that are generally classified on the basis of delinquency status.

OTS does not allow savings associations to use general valuation allowances to cover any amount classified as Loss; however, pursuant to 12 CFR § 560.160(b) a savings association may use Specific Valuation Allowances (SVAs) in lieu of charge-offs to record the loss, when appropriate, as discussed below.

OTS regulation 12 CFR 560.160 states:

> **Based on the evaluation and classification of its assets, each savings association shall establish adequate valuation allowances or charge offs, as appropriate, consistent with generally accepted accounting principles and the practices of the federal banking agencies.**

When a loss classification is determined, either by the savings association or examiners, an SVA can be used in lieu of charge offs when the institution determines that it is likely that the amount of the loss classification will change due to market conditions, such as when the value of security property increases or decreases. Such a situation may arise when there is a temporary impairment in the value of the security property. If the market value of a property improves or declines, the SVA can be reduced or increased. Once a charge-off is taken, however, the only way the institution can recover the loss is through the sale or the repayment of the loan or liquidation of the security property in an amount in excess of the recorded investment.

A savings association should not use an SVA in lieu of charge offs when it classifies certain credits as loss, such as unsecured loans, consumer loans, and credit cards, and in instances where the security property will likely be acquired through foreclosure (or repossessed as with personal property). In those cases, a charge off is appropriate.

Classification of Retail Credit

Retail credit, also called consumer credit, is defined as extensions of credit (including loans, overdrafts and leases) to individuals or families for personal, household or other nonbusiness purposes. Retail credit includes:

- Single-family, owner-occupied residential mortgages.
- Home equity loans and home equity lines of credit.
- Consumer installment loans, including auto loans, loans to finance recreational vehicles, and personal lease financing.
- Consumer overdraft accounts.
- Personal credit cards.

Evidence of the quality of retail credit is primarily indicated by the repayment performance of the borrower. When retail loans become seriously delinquent (90 days or more contractually past due), they display weaknesses that, if uncorrected, may result in a loss. As such, these loans are subject to classification. Because retail credit portfolios generally comprise a large number of relatively small balance loans, evaluating the quality of an institution's retail credit portfolio on a loan-by-loan basis is inefficient and burdensome to the institution and examiners. Once you determine that the institution has established and is following prudent underwriting standards and loan administration policies and procedures (including loan re-aging and modification standards), you should classify retail credits based on reliable delinquency data.

The Federal Financial Institutions Examination Council issued the Uniform Retail Credit Classification and Account Management Policy (the Policy) in June 2000. OTS issued the Policy as CEO Letter 128. The Policy, which applies to all federally insured banks and savings associations, instructs institutions to classify consumer credit as follows:

Closed-end consumer credit:

- 90 to 119 days past due should be classified Substandard.
- 120 or more days past due should be classified Loss and charged off.

Open-end consumer credit, such as credit cards, lines of credit, and residential real estate loans:

- 90 to 179 days past due should be classified Substandard.
- 180 days or more past due should be classified Loss and charged off.

In addition, the Policy provides guidance in the following areas:

- <u>Loans secured by personal property</u>. In lieu of charging off the entire balance, loans with non-real estate collateral may be written down to the fair value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
- <u>Residential real estate loans.</u> The institution should classify as Substandard one- to four-family residential real estate loans and home equity loans that are delinquent 90 days or more.
    - When a closed-end or open-end residential real estate loan becomes 180 days or more past due, the entire outstanding balance is not automatically charged off. The real estate collateral may protect the institution from experiencing a complete loss. The institution should determine the fair value less cost to sell of the real estate collateral. This may be done by reviewing an appraisal or evaluation on file, provided it is no more than 12 months old, and there have been no material changes in the market conditions or physical aspects of the property securing the loan. When the institution's recorded investment in the loan exceeds the fair value of the property less cost to sell, it should classify any excess amount as a Loss and charge it off. The institution should classify the remaining balance Substandard because the loan is not performing. In addition, during the time necessary to foreclose and sell the property, further loss may occur.

— Properly secured residential real estate loans with reliable LTV ratios of 60 percent or less are generally not classified solely based on delinquency.

- Bankruptcy. The institution should charge off unsecured retail loans to borrowers who subsequently declare bankruptcy within 60 days of receipt of notification of filing from the bankruptcy court, or within the charge-off time frames specified in the Policy, whichever is shorter.

- Fraudulent loans. The institution should charge off fraudulent loans within 90 days of discovery, or within the charge-off time frames specified in the Policy, whichever is shorter.

- Deceased borrowers. In cases where a borrower dies, the institution should charge off loans to the deceased borrower when it determines the loss amount but no later than the charge-off time frame.

- Partial payments. The Policy allows institutions to give borrowers credit for any portion of a payment they make. For example, if a borrower makes a half payment each month for 6 months, they would be, from an amount due perspective, 3 months past due. As a practical matter, an institution may consider payments of 90 percent or more of the amount due a full payment for purposes of determining delinquency status.

Re-aging, extensions, deferrals, renewals, and rewrites

Associations can use re-aging of open-end accounts and extensions, deferrals, renewals, and rewrites of closed-end loans to help borrowers overcome temporary financial difficulties, such as loss of a job, medical emergencies, or change in family circumstances. A permissive policy on re-aging, extensions, deferrals, renewals, and rewrites can cloud the true performance and delinquency status of an institution's portfolio. However, prudent use is acceptable when it is based on a borrower's renewed willingness and ability to repay the loan, and when the institution structures and controls such practices in accordance with sound internal policies.

The Policy also details criteria that institutions should meet before revising a delinquent account to report it as current. This includes maintaining comprehensive risk management and internal controls so that management can adequately control and monitor re-agings. You should verify these internal controls.

The institution's management information systems (MIS) should support re-aging decisions, like any other modification of contractual terms.

The institution should document such actions, including information on the re-agings granted, the institution's personnel who communicated with the borrower, and the borrower's agreement to repay the loan in full as well as his/her willingness and ability to do so.

MIS should also monitor and track the volume and performance of re-aged loans.

Open-end loans. For an open-end account to be eligible for re-aging, it should meet the following criteria:

- The borrower should show a renewed willingness and ability to repay the loan.
- The account should exist for at least nine months.
- The borrower should make at least three minimum consecutive monthly payments or an equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.
- A loan should not be re-aged more than once within the preceding 12 months, nor more than two times within any five-year period.
- An over limit account may be re-aged at its outstanding balance (including the over limit amount, interest, and fees) provided that no new credit is extended to the borrower until the balance falls below the pre-delinquency 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 monthly payments or the equivalent cumulative amount as agreed to 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 12 months and twice in five-year period limitation described above. MIS systems should track the effectiveness of workout programs by program type.

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.
- Limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Prohibit additional advances to finance unpaid interest and fees.
- Management should establish and maintain comprehensive and effective risk management, reporting, and controls to support the collection process and to ensure timely recognition of losses.
- MIS should track subsequent principal and interest reductions and charge-off history of loans granted extensions, deferrals, renewals, and rewrites.

Other Considerations for Classification of Retail Credits

If an institution can clearly demonstrate that repayment will occur regardless of delinquency status, then such loan need not be classified as Substandard or Loss. An example of such a situation is when the loan is well-secured by collateral and is in the process of collection. "Well-secured" implies the loan is secured by liens on or pledges of real or personal property, including securities, that have a fair value sufficient to discharge the debt in full, or the loan is supported by the guarantee of a financially responsible party. "In the process of collection" infers collection is proceeding in due course either through legal action or, in appropriate circumstances, through collection efforts not involving legal action that are reasonably expected to result in repayment of the debt or its restoration to a current status, generally within the next 90 days.

This Policy does not preclude institutions or examiners from classifying a consumer credit after the account is delinquent for a shorter period than indicated in the Policy, or on an account that is not delinquent. An example would be a portfolio of extraordinarily poor quality loans with high delinquency and loss rates. However, when underwriting policies or quality control procedures are weak, or when the institution originates or purchases pools of loans with poor credit histories, you may consider the need for classification of such loans when they become 30 or 60 days past due. In rare cases, you may consider classifying the entire portfolio.

In addition to reviewing loan classifications, you should ensure that the institution's allowance for loan and lease losses provides adequate coverage for losses inherent in the portfolio.

Regulatory Reporting for Past Due and Nonaccrual

Pursuant to TFR instructions, an institution should report loans with payments contractually past due 30 or more days as "past due and still accruing" if it expects full payment of contractual principal and interest. The institution should report such loans as "nonaccrual" if it does not expect full payment of contractual principal and interest.

As stated above, loans 90 or more days contractually past due are considered to have well-defined weaknesses that could result in a loss. Therefore, amounts in excess of the fair value of the collateral, less cost to sell, should be classified Loss, and amounts up to the fair value of the collateral less cost to sell, should be classified Substandard. Even when a loan or pool of loans has been written down to fair value, there remains a distinct possibility of a loss and, therefore, such loans should generally be reported as nonaccrual.

Allowance for Loan and Lease Losses. Institutions must maintain an allowance for loan and lease losses (ALLL) at a level that is appropriate to absorb all estimated credit losses inherent in the loan portfolio. (See Examination Handbook Section 261, Adequacy of Valuation Allowances.)

Real Estate Acquired Through Foreclosure

Real estate acquired through foreclosure is initially reported at the fair value, less cost to sell, of the foreclosed asset. Institutions should classify the amount of the recorded investment in the loan[4] in excess of the fair value less cost to sell, as a Loss and charge it off. This Loss classification may not be represented by a valuation allowance. Subsequently, REO should be measured at the lower of its carrying amount or fair value less cost to sell. The institution must expense legal fees and direct costs of acquiring title to foreclosed assets as incurred. In its assessment of fair value, the institution should include a current appraisal at the time of acquisition (see § 560.172). Subsequent valuations of foreclosed assets should follow the guidance provided in Handbook Section 251, Real Estate Owned and Repossessed Assets.

Real estate acquired by foreclosure is generally an undesirable asset, and may be subject to additional losses, even when recorded at fair value. It, therefore, should generally be classified as Substandard. When the institution's interest in real estate owned (REO) is compared with a performing loan, it becomes evident that REO is a substandard investment. A loan generally is protected by the borrower's paying capacity and equity in the property. A performing loan earns interest and all the expenses of holding the property are borne by the owner/borrower. Conversely, REO is a non-earning asset with little or no cushion between the institution's recorded investment and the market value of the property. The association must expend time and resources to acquire, repair, maintain, and sell the property. Furthermore, the acquisition of the property indicates a lack of demand (at least at the current "asking price"). (Refer to Examination Handbook Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Loans to Facilitate the Sale of REO

Loans or contracts to facilitate the sale of foreclosed mortgages, though generally of higher risk due to high loan-to-value ratios, are not presumed Substandard. You should evaluate the loan based on the new borrower's ability to service the debt. Do not adversely classify loans to facilitate (or any other loan) merely due to a high loan-to-value ratio. When there is a material volume of these loans to facilitate, you should sample such loans to assure that sound underwriting criteria are followed. If the sample indicates that sound underwriting criteria are not being followed, you should consider reviewing a larger sample. If your review provides you with a sufficient degree of confidence that loans to facilitate are granted to borrowers with an ability to service the debt, then adverse classification should be limited to those loans that are more than 90 days past due.

Classification of Investment Securities

Investment securities are classified in accordance with the "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts" (Uniform Agreement) (CEO Letter 200, June 2004) issued by OTS with the other federal banking regulatory agencies.

[4] The recorded investment in the loan includes the unpaid principal balance, accrued interest, deferred origination fees and costs, purchase premiums or discounts as well as any direct write-downs taken. It does not include any valuation allowances established for the loan.

Savings associations should classify investment securities based on credit risk, not interest-rate risk. A decline in the market value of a security simply due to interest-rate fluctuations is not a basis for adverse classification. You should base your classification on the likelihood of timely collection of principal and interest and also market price depreciation due to credit quality concerns. However, market value declines in a security often portend performance problems.

In assessing the credit quality of securities, institutions and examiners should generally find the qualitative ratings provided by nationally recognized statistical rating organizations (NRSROs) to be reliable guides. You should become familiar with the various rating services and the qualitative standards implicit in their respective rating systems. For rating descriptions, see Examination Handbook Section 540, Investment Securities.

Securities that are currently rated in the first four rating categories by NRSROs are generally considered of investment quality and not adversely classified. Savings associations should maintain current rating and credit information on securities to assist in their assessment of credit quality.

Ratings by NRSROs are generally reliable, if current, but savings associations should not regard them as absolute evidence of overall credit quality. Neither you nor institution management should feel constrained from deviating from the published ratings based on current improvement or deterioration in the condition of the issuer. Often ratings' downgrades lag market price depreciation due to credit quality concerns. Market price depreciation for credit quality concerns is a prime indicator of a need to perform an updated analysis of the issuer's credit quality. It is the institution's responsibility to regularly assess the credit quality and applicability of ratings for securities in which it has a material investment. The principles underlying analysis of credit soundness are essentially the same as those applicable to loan analysis. The ultimate test of investment quality is credit soundness as evidenced by payment capacity and reliability.

Rating differences: Some debt securities may have investment quality ratings by one or more rating agencies and subinvestment quality ratings by others. You should generally classify such securities, particularly when the most recently assigned rating is not investment quality. However, you have the discretion to "pass" or classify a debt security special mention with both investment and subinvestment quality ratings. You may use that discretion if, for example, the institution has demonstrated through its documented credit analysis that the security is the credit equivalent of investment grade.

Split rated securities: Some individual debt securities have ratings for principal, but not interest. The absence of a rating for interest typically reflects uncertainty regarding the source and amount of interest the investor will receive. Because of the speculative nature of the interest component, you should generally classify such securities, regardless of the rating for the principal. Note that TB73a requires savings associations to purchase only securities rated investment grade for both principal and interest.

Subinvestment grade and nonrated securities: The Uniform Agreement states that subinvestment quality debt securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes debt securities and hybrid equity instruments (e.g., trust preferred securities) in grades below the four highest rating categories, unrated debt securities of equivalent quality, and defaulted debt securities. FIRREA mandates that "no savings associations may, directly or through a subsidiary, acquire or retain any corporate debt security not of investment grade."

A savings association may, however, legally hold a "fallen angel," that it purchased as investment grade and has subsequently fallen to subinvestment grade. An institution may also have acquired such securities prior to obtaining a thrift charter. When a savings association holds subinvestment grade or non-rated securities, you should determine if the securities are permissible and apply the classification standards outlined in the Uniform Agreement. If they are impermissible, consult with your Regional Office. Depending on the circumstances, the Regional Director may require the association to divest its interest in the securities. In such cases, the association should report the securities as held for sale, and record the investment at fair value. If the investment in a security is permissible, your classification assessment is based on the Uniform Agreement.

Treatment of declines in fair value below amortized cost on debt securities

The 2007-2008 financial crisis saw the fair value of many securities decline below their amortized cost basis and thus those securities were deemed impaired under GAAP. Thrift management must assess whether the fair value decline of a security below it's amortized cost basis represents a temporary or other-than-temporary impairment (OTTI). This assessment is important as it can directly affect the accounting treatment, impacting earnings and regulatory capital. In certain circumstances for debt securities, OTTI is separated into two components: (1) the credit loss amount, recognized in earnings; and (2) the amount related to all other factors (non-credit loss) recognized in other comprehensive income (OCI), net of applicable taxes. If the institution intends to sell the security or will be required to sell the security, the entire impairment amount is classified as loss. If this is not the case, only the credit loss amount is classified as Loss and the non-credit loss amount would be Substandard, unless a more severe classification is warranted based on the facts and circumstances. In summary, the impairment amount charged to earnings will be classified as Loss and the impairment amount recognized in OCI will generally be classified as Substandard.

If an institution's process for assessing impairment is considered acceptable, you may use those assessments in determining the appropriate classification of declines in fair value below amortized cost on individual debt securities. Any decline in fair value below amortized cost on securities will be classified as indicated in the table below. The following table outlines the uniform classification approach you should use when assessing credit quality in debt securities portfolios:

General Debt Security Classification Guidelines

	Classification		
Type of Security	*Substandard*	*Doubtful*	*Loss*
Investment quality debt securities with "temporary" impairment	---	---	---
Investment quality debt securities with "other-than-temporary" impairment	---	---	Impairment (See Note below)
Subinvestment quality debt securities with "temporary" impairment[5]	Amortized Cost	---	---
Subinvestment quality debt securities with "other-than-temporary" impairment, including defaulted debt securities	Fair Value	---	Impairment (See Note below)

NOTE: Impairment is the amount by which amortized cost exceeds fair value. If the institution intends to sell the security or will be required to sell the security, the entire impairment amount is classified as loss. If not, only the credit loss amount is classified as Loss and the non-credit amount would be Substandard unless a more severe classification is warranted based on the facts and circumstances.

Classification of Equity Investments and Mutual Funds

In general, savings associations are not permitted to invest in most equity investments. However, they may invest in equity securities (or mutual funds) of companies that only invest in assets that a savings association may invest in and hold directly, including mortgage, consumer and business loans, and investment quality securities. Because savings associations can only invest in investment grade securities, it may not invest in a company that holds or trades in nonrated or below investment grade securities.

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[5] For subinvestment quality available-for-sale (AFS) debt securities with "temporary" impairment, amortized cost rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value, is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities. Under GAAP, unrealized gains and losses on AFS debt securities are excluded from earnings and reported in a separate component of equity capital. In contrast, these unrealized gains and losses are excluded from regulatory capital. Accordingly, the amount classified Substandard on these AFS debt securities, i.e., amortized cost, also excludes the balance sheet adjustment for unrealized losses.

If a savings association holds equity securities in a mutual fund that invests only in investment grade securities, and some of those securities are later downgraded to non-investment grade, it may continue to hold those securities. The relative portion of the savings association's investment in the mutual fund should be classified. For example, a savings association holds $1 million in mutual funds of a company that invests only in investment grade mortgage backed securities. Twenty percent of the underlying MBS are downgraded to below investment grade. Therefore, the savings association should classify 20% of its investment in the mutual fund as Substandard. Using a more complex example, a savings association held the same $1 million, but all the underlying securities were downgraded with 20% below investment grade. The downgrades decreased the value of the underlying securities to 75% of book value. The savings association takes an OTTI and records its investment at $750,000. In that case, $250 thousand of the original investment would be classified as Loss (and written off) and 20% of the remaining book value would be classified as Substandard.

Debt and Equity Investments in Subordinate Organizations

An institution's investment in a subordinate organization may take many forms, some of which include:

- Debt investment through collateralized loans
- Unsecured loans
- Capital stock
- Capital infusions
- Guarantees of debt
- Retained earnings
- Letters of credit
- Assumption of debt
- Advances not typically documented as loans.

Institutions should periodically evaluate their investments in subordinate organizations and make any appropriate adjustments to the carrying value of such assets based on the evaluation. You should ascertain that the institution does this evaluation and adjustment. Also, you should verify that the subordinate organization's assets reflect generally accepted accounting principles (GAAP) valuation standards. Under GAAP, losses and allowances should be booked on the subordinate organization's accounts for any assets deserving such treatment. The effect on the organization's financial statements of any losses and allowances is reflected on the parent institution's quarterly thrift financial report under the appropriate GAAP accounting method – consolidation, equity, or cost method. You should, therefore, confirm that the investment is reported in compliance with GAAP.

To illustrate the differences among GAAP accounting methods, assume an institution has a $1 million equity investment in ABC, a subordinate organization that includes retained earnings of ABC and represents all of ABC's net worth. The institution has also guaranteed a $1 million loan from a third party to ABC, and has made $20 million in unsecured loans to ABC. ABC has a $10 million loan to a real estate developer that is secured by property recently appraised at $6 million. Provided there are no other sources of repayment of the $10 million loan, ABC will probably have to recognize a $4 million loss on its loan to the developer. That loss would eliminate ABC's equity and result in a negative net worth of $3 million on ABC's books. This illustration is referenced throughout the following discussion.

<u>Consolidated Subordinate Organizations/Subsidiaries</u>: The consolidation method is used when a thrift's ownership interest exceeds 50 percent and the parent exercises control over its subordinate organization. OTS's rules generally refer to such entities as "subsidiaries" or as "GAAP-consolidated subsidiaries." Consistent with GAAP, all losses of a GAAP-consolidated subsidiary flow through to the parent association. Based on the illustration, the $4 million loss on ABC's loan to the developer would be consolidated with the operating results of the parent institution. The balance sheets of ABC and the parent would be consolidated. Intercompany transactions, such as the $20 million in unsecured loans to ABC, would be eliminated. (See Appendix C in Section 430 for guidance on the reconciliation of parent/subordinate organization intercompany accounts for consolidated and unconsolidated entities.)

After you confirm that the reported investments reflect GAAP, review any classifications for subsidiaries that can materially affect the parent institution. An institution should review and, where appropriate, classify the assets of the subsidiary rather than its investment in the entity. In reviewing asset classifications, you should determine whether the subordinate organization is an "includable subsidiary" for capital reporting purposes under 12 CFR § 567.1. The assets of an includable subsidiary are consolidated with the assets of the institution and any intercompany transactions are eliminated in accordance with the TFR instructions which generally follow GAAP. Therefore, the institution and subsidiary must reconcile their capital and investment accounts and payable and receivable accounts.

If a subordinate organization engages in activities that are not permissible for national banks then it is a "nonincludable subsidiary," for capital purposes. You should, in general, not classify the assets of, or investments (debt and equity) in the subsidiary. The OTS's capital rule requires institutions to deduct all nonincludable investments in and advances to a subsidiary from core capital. Therefore, the institution is largely insulated from the risk presented. Theoretically, the institution could lose its entire investment in the subsidiary without any additional adverse effect on capital.

<u>Unconsolidated Subordinate Organizations</u>: Institutions report investments in unconsolidated subordinate organizations under the equity or cost accounting method. The equity method is generally used when the institution's ownership level is between 20 to 50 percent and no control exists. The cost method is used when the institution's ownership is less than ten percent without control. An institution's investment in unconsolidated entities is generally classified as an equity investment rather than a subsidiary under OTS's capital rule.

Under the equity method, an entity's losses decrease the book value of the parent's investment. The losses flow through the parent's income statement. The equity investment is then adjusted for profits or losses but generally, only will be reduced to zero. (The investment can be reduced below zero, but only under certain circumstances. For example, if losses exceeding the amount of the investment are recorded and guarantees exist, or management continues to fund losses, the investment may be reduced below zero.) Using the illustration, the institution would write-down its $10 million investment in the unconsolidated entity to zero. The parent would also write-down its $20 million in unsecured loans to ABC to $17 million to recognize the diminution in value of those unsecured loans. Although ABC would have a net worth deficit of $3 million on its books, the parent would report its equity investment on ABC as zero on the quarterly TFR.

Alternatively, under the cost method, adjustments to the book value of an investment are only made when permanent impairments in value occur. Based on the illustration, the institution does not generally make adjustments to its investment account to reflect its share of the entity's losses or earnings. However, the institution must evaluate such cost method investments to determine whether the loss in value is temporary or other than temporary. If deemed other than temporary, the cost basis should be written down to its fair value, establishing a new cost basis in the investment.

For OTS capital reporting purposes, investments in unconsolidated subordinate organizations that engage in activities permitted for national banks can be included in capital. You should review these investments and, as appropriate, classify the institution's loans to and investments in, the entity. Again, you should first confirm that the institution has evaluated the investments in and loans to the entity and that any appropriate adjustments to the carrying value have been made. You should also evaluate the entity's assets to determine the worth of the equity investment and the ability of the entity to repay any debts owed to the parent institution. Like any other asset at the institution level, for purposes of classifying an institution's loans to or investments in these entities, you should analyze the financial strength of the entity and the quality and sufficiency of collateral to determine the orderly repayment of any debt.

An institution's investments in unconsolidated entities that engage in activities <u>not</u> permitted for national banks must be deducted from its total rather than core capital. Loss of the investment would negatively affect regulatory capital. Therefore, when such investments subject the association to a sufficient degree of risk that is not fully addressed through the capital treatment, classification of the institution's equity investment may be warranted.

To summarize, after you confirm that reported investments reflect GAAP valuation standards, review the institution's internal self-classification procedures for investments. You should generally review classifications for subordinate organizations that can materially affect the parent institution's financial condition. You should also verify that the institution routinely evaluates its investments in and loans to subordinate organizations and that any appropriate adjustments are made to the carrying value of these assets.

Finally, when assessing classifications you should consider whether the institution and its subordinate organizations adequately maintain separate corporate identities. Section 559.10 requires that an institution and its subordinate organization operate in a manner that demonstrates to the public their separate corporate existence. In those instances where a subordinate organization is not being operated within an adequate degree of separation, the parent may be deemed liable for the obligations of the subordinate organization. (Review compliance with § 559.10 during the subordinate organization examination, as detailed in Examination Handbook Section 730, Related Organizations.)

Off-Balance Sheet Items

Off-balance sheet items may include loan commitments, guarantees, letters of credit, litigation contingencies, and servicing or recourse liabilities assumed through the sale of loans and leases. Institutions should classify off-balance sheet items when they expect to incur a liability or fund an obligation under the agreement, and such funding would leave the institution with a poor quality loan, or asset that would be adversely classified or charged off.

The classification of some common off-balance sheet items are discussed as follows:

Loan commitments: A loan commitment should be classified if you determine that the commitment is legally binding, funding of the loan is likely, and the resulting loan would be classified. You should evaluate the commitment as if funding has occurred, basing the portion you classify on the amount likely to be disbursed. Just as you would do in reviewing a loan, you should review current financial statements of the prospective borrower, along with any collateral, to determine risk of nonpayment.

> For example: A savings association commits to make a $20 million permanent take out loan on a shopping center currently under construction. When construction is almost completed, the area falls into an economic recession, and a major tenant informed the owner that it will terminate its non-cancelable lease agreement and pay the resulting penalty. The owner/borrower informed the institution it will be unable to lease out sufficient space to meet its expenses. Because the borrower is not well capitalized, management determined that the property, when completed, will be troubled, and collateral dependent. Management sought advice from its legal counsel, who informed management that it must fund the loan. Management determined that the fair value of the property will be $16 million upon completion. Management classified the $20 million loan commitment as $4 million Loss and $16 million Substandard, and established adequate valuation allowances to recognize the impairment.

Letters of Credit: You should review and classify letters of credit (LOCs), as appropriate, with the same criteria used for the classification of commercial loans if disbursement is likely and a credit weakness exists with the account party. In such cases, determine the appropriate classification, and require valuation allowances as appropriate. (Letters of credit are discussed in Section 215 of the Examination Handbook.)

> For example, an association issues a $1 million standby LOC as credit support to guarantee payment on a $10 million securitized pool of automobile loans on behalf of the investors (LOC beneficiaries). If the delinquencies within the pool become so large that the seller/issuer of the pool is unable to meet the terms of the securities contract (partial default), the beneficiaries will be able to collect the $1 million from the LOC issuer, who in turn will attempt to collect from the seller. If the collateral is insufficient to satisfy the obligation and repay the LOC issuer, a loss will result. You should review the LOC agreement, and the performance of the collateral pool, to determine the appropriate classification.

> An example of a problem LOC follows:

Year 1: No significant problems, but LOC issuer has poorly documented the credit and financial capacity of the bond issuer and has inadequate documentation of the pool's performance. Delinquencies begin to rise. The likelihood of payment under the LOC agreement cannot be determined. The LOC may be designated Special Mention if you believe that the rising delinquencies and other problems could, over time, adversely affect the institution's credit position.

Year 2: Delinquencies become so large that the bond issuer must make payments from its own limited cash reserves. The LOC is classified Substandard due to the likelihood of drawdown plus limited repayment sources.

Year 3: Bond issuer defaults, and the investors demand payment under the terms of the LOC agreement. During the course of the year, the full $1 million is paid to the investors. The payment by the association to the investors results in an extension of credit (loan) to the bond issuer. Since the loan is subordinate to the investor's interest and the automobile receivables' payments will primarily be used to repay investors, it is believed that the association will incur a significant loss. The loan is classified Doubtful or Loss.[6]

End of Year 3: Issuer files bankruptcy and bondholders stand to lose some of their investment. The LOC issuer charges off the $1 million advanced under the LOC.

<u>Loans in Process, Including Lines of Credit</u>: Similar to loan commitments, you should ascertain whether additional funding for loans in process or under a line of credit will occur. If losses are probable and estimable on loans where full funding has yet to occur, the appropriate amount classifiable is the gross amount of a loan, rather than just the funds disbursed to date. For example, assume an association has funded $400,000 of a $1,000,000 construction loan. Despite an estimated $700,000 as completed value, the institution has determined that full funding of the loan will occur. The loan is troubled and collateral-dependent and the expected cash flow from the collateral is insufficient to meet required principal and interest payments. Generally, the appropriate classification for this loan is $700,000 Substandard and $300,000 Loss.

<u>Litigation</u>: Probable and estimable losses from litigation are generally accounted for by the establishment of a liability, as opposed to a contra-asset account (specific or general valuation allowance). If, however, an adverse ruling is expected to result in the non-collection of an asset presently outstanding, you should classify the asset or portion of the asset and establish a specific allowance or charge-off for that amount.

You should footnote in the ROE all dollar amounts listed under an adverse classification heading for an off-balance sheet item to indicate that the adverse classification is contingent upon funding. However, the gross amount of the item is the basis for determining the amount classified.

The institution must establish specific allowances or charge-offs for assets classified Loss. Consider off-balance sheet items classified Substandard or Doubtful when assessing the adequacy of general valuation allowances.

[6] The association might just as appropriately charge off the loan at this point, depending on the perceived likelihood of repayment.

Other Assets

Other assets, such as fixed assets used for business operations, are depreciated and generally are not subject to adverse classification. Situations may arise, however, where such a classification is warranted. Other assets where classification may be warranted are discussed below:

Repossessed Assets: Institutions should record repossessed assets at the lower of the recorded investment in the underlying loan or the property's fair value on the date the institution takes clear title and possession of the property. Any excess of the recorded investment in the loan over fair value less cost to sell must be charged off. (Technically the loan is charged off and the repossessed asset is recorded.) Where the repossessed assets are vehicles, this value is the wholesale amount a dealer will give the institution for the vehicle, adjusted for any cost needed to make the vehicle ready for sale.

The loss amount is charged against any specific allowance on the asset. Any remaining loss amount should be charged against the Allowance for Loan and Lease Losses account. Generally, repossessions should be disposed of in a reasonably short period of time. As noted with REO, holding repossessed assets for more than a few months indicates that there is no demand for the assets at the institution's selling price. You should review the institution's valuation methodologies and initiate corrective action where necessary. (Refer to Examination Handbook Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Accrued Interest Receivable: Accrued interest receivable is considered a part of the investment in the loan that must be evaluated for collectibility by considering the value of the collateral and any other sources of repayment. Any accrued interest where collection is not expected should be classified Loss. Otherwise, accrued interest should be accorded the same classification as the underlying loan.

Differences in Accounts and Stale Items: Any unreconciled difference in accounts should be classified Loss if the difference cannot be located in a reasonable period of time. Types of other assets frequently used by savings associations are the various temporary holding accounts such as suspense, inter-office, teller, transit, and bookkeeping differences having debit balances. The institution should use these accounts only for temporary recording until the offsetting entry is identified and posted to the proper account. Nothing should be allowed to remain in those accounts for any significant length of time, normally no more than 30 days. All differences in accounts should be closed out at least quarterly. Unreconciled differences in "Due From" bank accounts should be reviewed, with long outstanding and undocumented differences considered for a Loss classification. You should also review other stale items, such as returned checks and overdue accounts receivable deemed uncollectible, for possible adverse classification.

Treatment of Guarantees in the Classification Process

The institution should base its review and classification on the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third-party guarantors. You should, however, consider the support provided by guarantees in determining the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor" as described below, may be sufficient to preclude, or reduce the severity of, the classification.

A guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor has both the financial capacity and willingness to provide support for the credit.
- The guarantee provides support for the indebtedness, in whole or in part, during the remaining loan term.
- The guarantee is legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations Relating to the Guarantor's Financial Capacity: The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, the institution should consider the number and amount of guarantees currently extended by the guarantor in order to determine that the guarantor has the financial capacity to fulfill all such contingent claims.

Considerations Relating to a Guarantor's Willingness to Repay: You should normally rely on the institution's analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the guarantor's "track record," including payments made on the asset under review and those made on the guarantor's other financial obligations.

You should give due consideration to those guarantors who have demonstrated their ability and willingness to fulfill previous obligations in your evaluation of current guarantees of similar assets. An important consideration is whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. You should give little credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.

You should also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the loan; or
- Where the guarantees are collateralized by readily marketable assets that are under control of a third party.

Other Considerations: In general, the institution should rely only on guarantees that are legally enforceable. All legally enforceable guarantees, however, may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, the institution should not be subject to significant delays in collection, undue complexities, or uncertainties about the guarantee.

You should also consider the nature of the guarantee. For example, some guarantees for real estate projects pertain only to the development and construction phases of the project. As such, these limited guarantees cannot be relied upon to support a troubled loan after the completion of those phases.

Also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of the guarantees should be a positive consideration in the classification process.

FDIC Loss Sharing Agreements

Under loss sharing, the Federal Deposit Insurance Corporation (FDIC) agrees to absorb a portion of losses on certain pools of loans from failed institutions that are sold to acquiring banks. For commercial loans, loss share agreements typically cover 80 percent of losses for a certain period, and the acquiring institution agrees to absorb 20 percent of losses. In most cases, assets are written down to their estimated fair value and the acquiring institution remits 20 percent of the fair value to the FDIC.

The acquiring institution services the pool of assets and remits 80 percent of the cash flows to the FDIC after servicing expenses. Your decision on whether to classify the 20 percent investment in the assets will depend on the quality of the assets and the details of the loss share agreement. If the assets perform better than expected, the investment would be profitable, and the acquiring institution would not experience any losses; however, if the assets perform worse than expected, it could suffer a loss on its 20 percent investment.

While the initial write down to fair value may be severe, depending on the quality and performance of the assets, losses may exceed those expected when they were written down to fair value. For instructions on how to review and risk rate/classify such investments, please refer to Interagency Supervisory Guidance on Bargain Purchases and FDIC-and NCUA-Assisted Acquisitions.

Conclusive Presumption of Worthlessness of Debts Held by Savings Associations

Institutions may elect to conform their tax accounting for bad debts with their regulatory accounting. Institutions that make this election can automatically deduct charge-offs of loss assets for federal income tax purposes in the same year the charge-offs are taken for regulatory purposes.

Institutions must maintain loan loss classification standards that are consistent with the standards established for loan charge-offs by its primary federal supervisory agency. If the institution meets these requirements, its loan charge-offs are conclusively presumed worthless for federal income tax purposes.

To be eligible, an institution must file a conformity election with its federal tax return. The IRS regulations also require the institution's primary federal supervisory agency to expressly determine that the institution maintains and applies classification standards for loan charge-offs that are consistent with regulatory requirements.

Procedures

The savings association is responsible for requesting an Express Determination Letter (Appendix A). When requested by a savings association that has made or intends to make the election under IRS regulation section 1.166-2(d)(3), you may issue the Express Determination Letter, provided the savings association maintains and applies loan loss classification standards that are consistent with regulatory requirements.

The Express Determination Letter should be issued only at the completion of an examination that covers the association's loan review process, and for which you have concluded that issuance of the Express Determination Letter is appropriate. You should not alter the scope or frequency of examinations merely to permit savings associations to make this election.

The examiner-in-charge should sign and date the Express Determination Letter and give it to the savings association for its files. The Express Determination Letter is not part of the examination report. You should document your conclusions regarding the association's loan loss classification standards in the examination work papers.

OTS standards for loan charge-offs and classification standards are set forth in Section 217 (Consumer Lending), Section 218 (Credit Card Lending), and this Section of the Examination Handbook.

You should only issue the Express Determination Letter if:

- Your examination indicates that the savings association maintains and applies loan loss classification standards that are consistent with OTS standards regarding the identification of losses and charge-off of loans.
- There are no material deviations from regulatory standards. Minor criticisms of the savings association's loan review process or immaterial individual deviations from regulatory standards do not preclude issuance of the Express Determination Letter.

Do not issue the Express Determination Letter if:

- The savings association's loan review process relating to charge-offs is subject to significant criticism.
- Loan charge-offs for TFR purposes are consistently overstated or understated.
- There is a pattern of loan charge-offs not recognized in the appropriate year.

Revoking the Election

The savings association's election is revoked automatically if you do not issue an Express Determination Letter at the end of an examination that covers the loan review process. The OTS is not required to rescind any previously issued Express Determination Letters.

Your decision to withhold the Express Determination Letter generally revokes the election for the current year. However, it does not invalidate a savings association's election for any prior year(s). Withholding the Express Determination Letter places the burden of proof on the association to support its tax deductions for loan charge-offs.

INTER-REGION CLASSIFICATIONS

Classification of an asset held by associations in more than one region is the primary responsibility of the region in which the lead association is located (lead region). When the lead region has determined the appropriate classification, it should distribute the classification write-up, as presented in the ROE, and documentation on how the classification was determined to the regions that have associations participating in the asset (participating regions). The documentation should include the calculations used to determine any Loss classification. A Pass classification should also be communicated to the participating regions.

Regional Offices may direct associations in their region, or their affiliates or service corporations, to adjust the book value of an asset. Where participants are regulated by another region, the Regional Office of the lead lender will provide key information to other Regional Offices, including the adjustment to the book value and a copy of the appraisal report, if applicable. The Regional Office of the out-of-region participants should, in turn, communicate the appropriate adjustments to the asset's book value to their associations. The institution should charge off assets or establish loss allowances in accordance with GAAP and OTS policy.

The lead lender or any participant has the option to file a request for an informal review pursuant to Thrift Bulletin 68b as a result of a classification, an appraised value, or a directive to establish allowances.

Regional Offices of the lead lender and all participants should ensure that within 30 days of being notified to charge off an asset or establish an allowance, all associations, service corporations, or affiliates have taken appropriate action or have submitted a written explanation concerning why it did not do so. In the absence of an explanation, or the establishment of an allowance or charge-off, the Regional Office should initiate necessary supervisory action.

If the lead region has yet to review an inter-region asset, the participating region, pursuant to an examination, should review the asset and determine an appropriate classification. If adversely classified, the write-up should be forwarded to the lead region. The write-up may also be sent to other participating regions for informational purposes. This same procedure should be followed in those instances where information has been received subsequent to a lead region's classification, which renders such classification dated and inappropriate.

Shared National Credits

Overview of the Program. The Shared National Credit (SNC) Program is an interagency effort designed to evaluate the largest and most complex syndicated credits. The program is conducted annually by the federal banking regulatory agencies (agencies) including the Office of Thrift Supervision (OTS), Federal Reserve System (FRS), Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), as well as cooperating state banking supervisors such as the New York State Banking Department (NYSBD).

The reviews are conducted in late April to early June. Individuals designated as the Examiner-In-Charge (EICs) communicate the preliminary results of their particular review at the conclusion of their respective review to pertinent management of the institution.

Formal Notification of Results and CEO Letter. The collective formal results are mailed to the agent and participant institutions annually in late August by the respective federal banking agency. Formal results are detailed for the applicable institution on credits that they agent or participate in via a Report of Lenders and Their Borrowers summary document, which is accompanied by applicable loan write-ups for criticized credits.

A Memorandum to the Chief Executive Officer (CEO letter), which accompanies the mailing of the formal results, details information pertaining to the confidentiality of SNC ratings. Additionally, the CEO letter details information on the treatment of loss rated and nonaccrual facilities and changes in SNC ratings between SNC reviews. Specifically, the guidance to institutions is outlined in the following two points below:

1) It is expected that your organization will charge off its share of any loss classification by September 30. Any charge-offs associated with these SNC credits not already taken should be reflected in your third quarter Thrift Financial Report. A specific date of non-accrual has been provided in the report and write-ups for credits placed on non-accrual status during the SNC review. Banks and savings associations should not accrue interest, amortize deferred net loan fees or costs, or accrete discount beyond the designated non-accrual date.

2) When there is a material change that could affect the rating of a credit, the agent/review financial institution should contact Carolyn Engelhardt, Financial Analyst, and its regional caseload manager. In that notification, include sufficient financial and other supporting data to enable us to determine if a supplemental review is necessary. Participating financial institutions are encouraged to revise their internal risk ratings of SNC facilities between SNC reviews to properly assess and report credit risk.

Aggregate Results. The aggregate results are published annually (September) in an interagency press release.

Appeals. Regarding the appeals process, OTS utilizes the general guidance outlined by the OCC in banking issuance OCC 2002-9; however, if the institution decides to file an appeal it must be with their primary regulator, the OTS. Additionally, the appeal should be made within 14 days of notification of the preliminary disposition by the EIC at the conclusion of the SNC review for the applicable institution.

WORK PAPER DOCUMENTATION

You must adequately document your examination findings in the examination work papers. As with all examination work papers, your Classification of Assets work papers should:

- Contain clear conclusions and concise analysis.
- Provide sufficient documentation of findings.
- Be properly indexed.
- Reference all pertinent information sources.

In addition, documentation supporting classification of assets must include:

- Clear documentation of your reason(s) for classification decisions.
- A comparison, by classification category (Substandard, Doubtful and Loss), of your total classified assets to the institution's total classified assets.
- A clear conclusion concerning the adequacy of the institution's self-classification policies and procedures.

REFERENCES

Code of Federal Regulations (12 CFR)

Section 559.10	Separate Corporate Identities
Section 560.30	General Lending and Investment Powers of Federal Savings Associations
Section 560.32	Pass-Through Investments
Section 560.40	Commercial Paper and Corporate Debt Securities
Section 560.160	Asset Classification
Section 560.172	Re-Evaluation of Real Estate Owned
Section 561.12	Consumer Credit

Section 561.44	Security
Section 564	Appraisals
Section 567.1	Regulatory Capital Definitions

CEO Letters

CEO Letter 128	Revised Uniform Retail Credit and Account Management Policy
CEO Letter 200	Classification of Assets and Appraisal of Securities
CEO Letter 325	Guidance on Prudent Commercial Real Estate Loan Workouts

Office of Thrift Supervision Bulletins

TB 68b	Appeals and Ombudsman Matters

Financial Accounting Standards Board, Accounting Standards Codification (ASC)

ASC 310-40	Receivables - Troubled Debt Restructurings by Creditors
ASC 360	Property, Plant and Equipment
ASC 450	Contingencies
ASC 805	Business Combinations
ASC 840	Leases
ASC 948	Financial Services