# Examination Process – Lending, Collections and Allowance for Loan Loss Review

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Loans usually represent the largest asset category and the most time consuming part of the examination process. The appraisal of the loan portfolio is a good measure of a credit union's financial soundness, its service to members, and the quality and focus of management.

**Objective of Loan Review** – The objective of the loan portfolio analysis is to determine:

- The quality of the loan portfolio;
- The risk posed by the loan portfolio to the credit union's capital;
- The collection probability of delinquent loans;
- The quality of the loan policies, procedures, and internal controls governing loan underwriting;
- That credit union employees operate in accordance with board established policy; and
- That management initiates timely corrective action when deficiencies exist.

**Scope of Loan Review** – A credit union's loan portfolio is usually its primary source of income as well as a major source of risk to its institutional capital. The loan analysis determines the quality and overall risk of the loan portfolio. Examiners must select and review an adequate sample of loans in order to make an informed decision on the quality and risk of the loan portfolio. If, after reviewing the prior examination report and annual audit, interviewing loan officers, evaluating lending internal controls and reviewing examination period changes to loan policies and procedures, examiners uncover no significant lending problems and no significant changes to loan policies or personnel, then examiners may review a minimum sample of the loan portfolio. Examiners should select a loan sample that is representative of the loan portfolio.

In larger, more complex credit unions, examiners should consider whether, and to what extent, a larger loan sample should be reviewed. Additionally, when examiners identify material concerns during a reduced or normal scope loan review, they should expand procedures to better determine the severity of the problems and to devise plans to correct problems.

The reduced scope review requires that the examiner select a sample from the loan trial balance that includes, at least the following:

- **Charged off Loans** – Scan the charged off loan list for unusual activity and review basic internal controls (board approval, proper accounting, procedures used to assign loans to a collection agency, etc.). Examiners are not required to review individual charged off loan files. However, where problems are noted, examiners may expand the scope to review individual charged off loans to determine the extent of the problem and to develop corrective action plans.
- **Delinquent Loans** – At a minimum, scan the delinquency list for unusual activity. Consider reviewing larger and more recently granted delinquent loans. Examiners

should review loans that were seriously delinquent at the last exam and are still delinquent. They should also determine how a sample of loans on the delinquency list at the last examination, or as of a selected month-end during the examination period were removed from the delinquency list.

- **Current and New Loans –** The examiner should select a random sample of current loans and loans granted since the last examination. Within this sample, the examiner should review all of the different types of loans granted by the credit union and the sample should also include a sample of loans granted by all of the loan officers and officials with credit granting authority.
- **Insider Loans –** All loans made since the last examination to officials, credit union supervisory staff, and their immediate family members should be examined. During the examination of larger credit unions, examiners should consider reviewing loans of non-supervisory staff. The examiner should also review the applicable savings and loans balances; any large or unusual transactions should be verified.
- **Large Loans and Concentrations of Credit -** The examiner should select a sample of loans and concentrations of credit to one borrower or a group of related borrowers that are greater than 10% of institutional capital.
- **Member Business and Real Estate Loans –** A sample of business and housing or mortgage loans should be selected. These loans generally have larger balances and pose greater risk to the credit union's institutional capital. Examiners should review different member business and real estate loan files at each examination. To provide adequate follow-up from one exam to the next, examiners should review the payment history of loans that were reviewed during prior examinations to verify that borrowers continue to pay as agreed.
- **New Loan Program –** If any new loan programs have been initiated since the previous exam, a sample of these loans should be selected for review.

**Loan Policy Review** –Prior to reviewing the selected loan sample, the examiner should review the loan policy. The loan policy should be reflective of current operations. The board of directors should review and revise the policy no less than annually. The date of the review should be noted on the policy and/or in the board minutes. The loan policy should address the following areas, at a minimum:

- ♦ How does a member become eligible to apply for a loan;
- ♦ Types of loans granted;
- ♦ Terms for each loan type;
- ♦ Types of collateral accepted;
- ♦ Desired loan portfolio diversification based on collateral;
- ♦ Maximum loan terms and available payment plans;
- ♦ Interest rates and applicable fees for all loan types;
- ♦ Definition of a credit concentration as compared to institutional capital;
- ♦ Loan officer authority;
- ♦ Loan approval process;
- ♦ Loan documentation requirements for each loan type;
- ♦ Requirements for co-signers;
- ♦ Debt to income ratio standards; and

- Process and documentation needed to disburse a loan.

**Loan Review Workpaper -** Examiners may document their review on a self-designed workpaper that includes the following information:

- The borrower name and account number;
- The outstanding loan balance as of the exam date;
- The date the loan was granted;
- Who granted the loan and was the loan within their authority;
- The type of loan;
- The collateral used to secure the loan;
- The value of the loan collateral;
- The borrower's debt to income ratio;
- Amount of insurance on the collateral, if applicable;
- If the credit union properly secured its lien against the collateral; and
- Any examiner comments.

All of this information should be noted for each loan file reviewed and clearly documented on the workpaper. The workpaper should be clear and concise so that it may be reviewed and used at subsequent exams. These workpapers should be included with the final report that is retained by the regulatory agency.

**Loan Documentation Review –** Adequate loan documentation is instrumental in determining the borrower's ability to repay. If examiners note a lack of documentation, especially in credit unions with serious or potentially serious financial problems, they should develop corrective action plans with management. Adequate loan documentation includes the following:

- A completed loan application along with documented approval;
- Documented creditworthiness analysis including debt ratio analysis and computation and verification of income and expenses;
- A completed note and security agreement;
- A perfected collateral lien and adequate insurance, if available;
- Evidence of collateral value (e.g. purchase invoice, appraisals); and
- Adequate information to assess the co-signer's ability to repay.

**Lending Practices Review –** The practices the board or loan officers follow determine the lending program's effectiveness. Examiners ascertain these practices during the loan review by reviewing policies, board minutes, loan officer minutes, and the loan files. When appraising practices, the examiner determines:

- **Adequate borrower information is obtained.** A complete and accurate application allows the loan officer to appraise the applicant's willingness and ability to repay. The loan application should document the applicant's income source and stability as well as their obligations.
- **That the loan officer has adequately assessed the borrower's ability to repay the loan.** Loan officers should include the new loan in addition to all existing obligations when calculating the expense to income ratio and the borrower should clearly

demonstrate that they are able to repay the loan based on their income as of the date of the loan.

- **Loan officers verify pertinent borrower information.** Borrower income should be verified by requesting a recent pay stub or summary, contacting the employer, requesting a tax return from the borrower, or by contacting individuals with similar employment. Large debts or expenses and their terms should also be verified if possible.
- **Collateral is owned or titled in the name of the borrower.** The borrower has sufficient equity in the collateral so that they will not surrender it easily, the loan repayment schedule reduces the loan balance as quickly as the collateral depreciates, the collateral value is known and is easily documented, and the collateral can readily be converted to cash.
- **The board established reasonable credit guidelines.** These guidelines should manage delinquency and loan losses as well as providing quality member service.
- **Board or loan officer actions are within their written authority.** If loans are approved outside of an employee's authority, there should be a clear explanation as to the reason.
- **Segregation of Duties exists.** No one employee or official should be able to take a loan application, approve the requested loan, disburse the funds, and perform the accounting transactions.
- **Loan interest rates are competitive with the market.** If loan rates are above market, the credit union risks attracting borrowers that can not obtain loans at other financial institutions, and if rates are too low then profitability could be negatively impacted.
- **Variable interest rates adjust accordingly.** If loans are granted with variable interest rates, the interest rate should be tied to an index that reflects changes in the market and the loan interest rates should be adjusted per the loan agreement.

**Signs of Warning –** These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of loans, the examiner should look for the following signs of warning:

- Large or increasing volume of loans granted or renewed with policy exceptions;
- Large or increasing volume of credit/collateral exceptions;
- Loans that are delinquent for extended periods of time without any payments or communication;
- Line of credit loans with balances in excess of the maximum approved amount;
- Loan balances that are greater than the value of the collateral;
- Loans granted to minors;
- Credit union employees that can both approve and collect loans;
- Large concentrations of credit to individuals or a group of related borrowers granted with or without board approval;
- Loans to officials, employees, and their relatives that are outside of policy;
- Rapid growth in total loan volume or certain types of loans;
- Growth in the Allowance for Loan Loss account that is significantly greater or less than the percentage growth in total loans;

- Non-performing loans or problem loans as a percentage of total loans increasing at a greater rate than the Allowance for Loan Loss account;
- High or increasing yield on the loan portfolio when market interest rates are flat or declining;
- Significant increase in the number or dollar amount of problem loans as a percent of loans;
- Loan files selected for the loan review sample that can not be located; and
- Numerous loan extensions and/or refinances granted.

**Loan Deficiencies –** During the review of the individual loan files the examiner identifies as specific loan exceptions: documentation deficiencies, loan processing exceptions, violations of rules and regulations and applicable law, violations of the credit union's lending policy, and poor loan underwriting criteria. General loan exceptions will also be noted. These exceptions are more global; they may apply to numerous loans or a loan policy. They do not discuss the exception in light of one borrower. All examiner exception comments, whether specific or general, should be disclosed on the Loan Exception document. If the problems or errors are chronic and/or could have a material effect on the credit union's financial position then these issues should be addressed in the Document of Resolution.

The loan exceptions document should be used at each examination as a tool, to follow-up and determine if the problems and errors identified at the last examination have been corrected.

**Determining the Adequacy of the Allowance for Loan Loss Account –** This account serves as a reserve valuation account, with the purpose of fairly disclosing the value of the loan portfolio. The examiner should review the credit union's funding of the account to determine the account balance represents a reasonable estimate of potential loan losses.

Determining the adequacy of the allowance account is part of each examination. The examiner should obtain the loan classification prepared by the credit union. In lieu of performing their own classification, examiners can review and analyze the adequacy of the credit union's classification, the reasonableness of any assumptions made, and the quality of supporting documentation. Additionally, examiners can ascertain that staff members performing the individual classifications are familiar with collection procedures and borrower payment performance. If the examiner feels that the credit union classification is adequate, it may be used as the workpaper and included in the final report retained by the regulatory agency. The examiner may add additional comments to the credit union's classification if needed.

The credit union's classification should clearly state all of the loans in which management does not expect to collect 100 percent of the loan balance. The classification should include:

- The borrower's name and account number;
- The outstanding amount of the loan as of the date of the report;
- The expected loss expressed as a percentage of the loan balance;

- The total amount classified as a potential loss compared to the balance of the Allowance for Loan Loss account and any difference; and
- Any comments with respect to loan collectibility, value and condition of the collateral, adequacy of insurance, likelihood of collection from a co-signer, if applicable, etc.

If the loan classification is inadequate, the examiner should prepare a classification and provide a plan for corrective action in the Document of Resolution. Normally, examiners determine the amount of collection problem loans based on the number of months delinquent, although a loan does not have to be delinquent to be classified. If a loan is current and credit union staff is aware that a potential loss exists, then that loan should be classified. This classification identifies loans as substandard, doubtful, or loss:

- **Substandard Loans –** Loans classified as substandard have characteristics that jeopardize loan collection. Examiners normally classify at least 25 percent of the loan balance as a potential loss. Examples of substandard loans include:
  - Loans in which the credit union would have a loss due to collection costs;
  - Loans in which the credit union will not collect a substantial amount of the total even though the borrower makes partial or irregular payments;
  - Delinquent loans with inadequate co-signer information,
  - Loans in which the lien on the collateral was not properly secured; or
  - Loans in which the payments are current but represent a potential loss because of the payment terms or past payment history.

- **Doubtful Loans –** Loans in this category possess all the weaknesses inherent in a loan classified as substandard, with the added characteristic that the weaknesses make full collection improbable. Loans classified as doubtful should be considered a 50 percent loss. Examples of doubtful loans include:
  - Delinquent loan balance that exceeds the collateral value; or
  - Delinquent borrowers who have not been able to consistently make payments.

- **Loss Loans –** Loans classified as a loss are of such little value that they should no longer be considered a loan on the balance sheet. Unless management can support collectibility, they should classify loans in this category as a 100 percent loss. Examples of loss loans include:
  - Any loan six months or more past due without a payment in the last 90 days of at least 75 percent of a regular monthly installment;
  - Delinquent loans with an attorney or at a collection agency;
  - Delinquent loans in which the borrower can not be located; or
  - Loans in which a deficiency balance remains after the sale of the collateral.

Examiners then compare the total of the classified amounts to the balance in the allowance account. If the loan classification differs significantly from the balance of the Allowance for Loan Loss account, the Document of Resolution should include a directive to immediately increase (or decrease) the account to meet full and fair disclosure.

**Signs of Warning –** These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of the adequacy of the Allowance for Loan Loss account, the examiner should look for the following signs of warning:

- The account balance is consistently less than the classified loan amount;
- Management is repeatedly over optimistic with regards to the amount that can be collected on the classified loans;
- Loans were charged off (a debit in the allowance account) that were not approved for charge off in the board minutes; and
- The external and/or internal auditor does not periodically review the allowance account activity.

**Objective of Collections Review–** The principles of safety and soundness require the board of directors to establish and supervise an effective loan collection program. The review of the credit union's collection policy and operations is imperative during the examination to determine:

- Causes of delinquent loans;
- If collection techniques are results-oriented;
- If the collections department provides all the necessary information concerning the collectibility of the delinquent loans to management and officials;
- If the collection department staff is manipulating delinquent loan accounts to reduce delinquency; and
- Any corrective action plans needed to improve collections.

**Collection Policy –** Prior to reviewing the operations and results of the collection department, the examiner should review the written collection policy. The policy should be reviewed and revised by the Board no less than annually. The date of the review should be documented on the policy and/or in the board minutes. The policy should include the following, at a minimum:

- Who is responsible for collections;
- When a loan is considered delinquent;
- Reporting requirements to the board for delinquent loans;
- Timeframes for making collection contacts with delinquent borrowers;
- When the co-signer will be notified, if applicable;
- How and when collateral is to be repossessed;
- How the collateral should be sold;
- Collection system used to document contacts with delinquent borrowers;
- The approved use of loan extensions and loan refinances;
- Who has the authority to approve loan extensions and refinances;
- When loans are to be charged off;
- How recoveries on charged off loans will be handled; and
- Any fees and penalties associated with delinquent loans.

**Collection Procedures Review –** An accurate list of delinquent loans must exist for the examiner to evaluate collection policies and practices. The delinquency list should provide the following information:

- Borrower name and account number;
- The outstanding loan balance;
- Date the loan was granted;
- Breakdown of delinquency in categories – 0-30 days delinquent, 30-60 days, 60-90 days, 90-120 days, 120-180 days, 180-360 days, and greater than 360 days delinquent (the outstanding loan balance is considered delinquent, not just the delinquent amount);
- Date of the last payment received;
- Amount of the last payment received; and
- Comments and additional information.

Examiners should select a sample of the loans on the delinquency list and test the accuracy of the credit union's delinquency calculations. If the sample tested reveals loans improperly categorized on the delinquent loan schedule, this should be addressed either in the Examiner Findings or the Document of Resolution, depending on the severity of the problem.

Examiners should also compare the delinquent loan list as of the examination date to another month-end delinquency list and determine how loans were removed from the list. Examiners must keep in mind that loans can only be removed from the delinquent loan list by:

- Paying the loan current;
- Extending the loan maturity date or refinancing the loan; or
- Charging the loan off to the Allowance for Loan Loss account.

Lastly, the examiner should interview the collection department manager to learn about the collection procedures used. This step could be brief, if delinquent loans are not a problem or quite lengthy if delinquent loans are increasing, reducing loan income, and/or negatively impacting the credit's institutional capital. The purpose of this interview is to develop corrective action plans that will be addressed in the Examiner Findings or Document of Resolution, depending on the severity of the problem.

**Signs of Warning –** These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of the collection area, the examiner should look for the following signs of warning:

- Credit union employees that have the authority to approve and disburse loans, and collect delinquent loans;
- Numerous loan extensions and/or refinances granted;
- Adequate time is not given to loan collections, if collections is performed by an employee with other job duties;
- Collection personnel does not have adequate training;
- Collection personnel that lack the attitude and personality needed to collect loans;
- Collectors that have access to credit union cash;

- Collection agencies or outside third parties that do not provide a monthly activity report; and
- Suspicious relationships or activities between the collector and third party agents used to sell repossessed collateral.

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