Classifying Assets Using the UCS

This Farm Credit Administration (FCA) document is an extension of the EM-22.2 Risk Identification Examination Manual section. It provides additional, supporting information and examination guidance.

Appropriately assigned Uniform Classification System (UCS) classifications are based on thorough analysis of a borrower's five primary credit factors, commonly referred to as the 5 C's of credit (capacity, capital, collateral, character, and conditions). Proper analysis of all credit factors is essential to identify the risks and creditworthiness of a borrower and apply the UCS definitions consistently. The guidance below provides a definition of each UCS classification, the credit factor characteristics associated with each classification, and key considerations in assessing the 5 C's of credit. Refer to FCA's FAQs About Risk Identification for additional guidance on using the UCS and assigning classifications under different scenarios.

Note: Institutions may implement lending programs, such as scorecard lending, that do not include a comprehensive 5 C's analysis and involve assigning a UCS classification based on a numeric score.

UCS Classifications

Acceptable

Definition: *These are noncriticized assets typically characterized by sound financial condition and repayment capacity, adequate collateral, appropriate loan structure and conditions, and no character concerns. These assets generally have no consequential adverse trends that pose a near-term risk to repayment capacity. If any credit factor weaknesses exist, they must be relatively minor or mitigated by strengths in other credit factors. This category also includes assets with valid and properly-serviced U.S. government guarantees or Federal Agricultural Mortgage Corporation (Farmer Mac) Long-Term Standby Purchase Commitments (standby commitments).*

General Characteristics: The following are general characteristics of an Acceptable loan. Not all of these characteristics need to be met if sufficient offsetting strengths exist in other credit factors.

- Earnings performance and capacity remain sound, with any losses short term in nature and not a significant threat to the borrower's repayment capacity and financial condition. Performance is favorable compared to industry peers, and repayment problems are not likely in the foreseeable future.

- Financial position provides sufficient risk-bearing ability to support continuation of the business and liquidity needs throughout industry cycles.

- Character is sound, with no significant concerns in risk, production, or financial management. The borrower maintains a constructive relationship with the lender, complies with loan conditions, and is willing and able to address lender concerns.

- Loan structure, terms, and conditions are appropriate for the loan purpose and borrower's risk profile.

- If collateral is required, it is adequate as a secondary source of repayment. Any subsequent declines in value do not threaten the primary source of repayment.

- Credit administration is sound and any deficiencies do not materially increase risk to the institution.

Supplemental Guidance: While assets with U.S. government guarantees or Farmer Mac standby commitments are typically classified Acceptable, the enforceability of the guarantee is of critical importance in making this determination. FCA provided guidance on this topic in Informational Memorandums on Examination of Loans Guaranteed by Federal and Local Government Agencies dated July 10, 1998, and Long-Term Standby Purchase Commitments dated May 2, 2012.

Some personal or other nongovernmental guarantees can also be a sufficient credit enhancement to support an Acceptable classification on an otherwise criticized or adversely classified asset. However, there are many variables to consider in determining a personal or other nongovernmental guarantee's value as a credit enhancement.

Refer to the *Credit Enhancements (Guarantees)* section in FCA's FAQs About Risk Identification for additional guidance on how guarantees and standby commitments impact UCS classifications.

Special Mention

Definition: *A Special Mention asset (also known as Other Assets Especially Mentioned) 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.*

General Characteristics: The following are general characteristics of a Special Mention loan. These characteristics may not always result in a Special Mention classification if sufficient offsetting strengths exist in other credit factors.

- The borrower is experiencing adverse trends or weaknesses in earnings or capacity that have not reached a point where repayment is jeopardized.

- The borrower is experiencing adverse trends or weaknesses in equity or liquidity positions that have the potential to impact the borrower's ability to service the debt.

- Collateral is not yet relied on for repayment, but conditions may exist that pose potential concerns regarding the existence, collectability, or value of collateral. For example, a significant decline in collateral values could lead to an undersecured collateral position and increased potential for a "strategic default" by the borrower.

- The borrower's risk management practices, production management, or financial management represent a potential weakness. The weakness may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. In addition, the borrower may be slow, unwilling, or unable to adjust operations and correct the potential weakness. Examples include failure to obtain sufficient insurance coverage, poor marketing decisions, or expanding operations without adequate consideration of costs, leverage, or liquidity. The borrower may have also made a poor management decision, and the full impact of such decision is not fully known or recognized.

- Loan structure, terms, and conditions may deviate from prudent lending practices relative to the customer's risk profile and materially increase risk to the institution. Examples include structuring the loan maturity or amortization in excess of the useful life of the collateral or asset financed, indefinite or liberal repayment requirements (e.g., repayment highly dependent on refinancing), or nonexistent, weak, or waived loan covenants.

- Credit administration weaknesses materially increase risk to the institution.

Supplemental Guidance: These assets may have elevated credit risk, but not to the point of justifying adverse classification. FCA's position is that Special Mention can be used for both deteriorating assets being downgraded from Acceptable and improving assets being upgraded from an adverse classification. However, Special Mention is not a compromise between Acceptable and Substandard and should not be used to avoid exercising such judgment.

Substandard

Definition: *These assets are inadequately protected by the borrower's repayment capacity, equity, or collateral pledged. Assets so classified must have a well-defined weakness or weaknesses that jeopardize normal collection of the debt. They are generally characterized by the distinct possibility that the lender will sustain some loss if the deficiencies are not corrected.*

General Characteristics:

- Unprofitable operations result in inadequate debt servicing capacity and could raise concerns regarding the borrower's viability. Voluntary or forced liquidation of collateral or other assets may be needed to repay the loans.

- The borrower has inadequate liquidity or a weak equity position. The cause of weak financial condition could be internal factors (increasing or excessive debt load, poor management decisions, etc.), or a combination of internal and external factors (e.g., poor management or operational decisions coupled with depressed prices or declining asset values due to economic conditions).

- Collateral may be inadequate to cover all outstanding debt. While inadequate collateral alone would not be a basis for a Substandard classification, when combined with weaknesses in other credit factors, it increases the possibility of a future loss.

- Serious concerns exist with the borrower's risk management, production, or financial management. This could be an isolated decision with a material negative impact on the borrower's financial or operational condition, or a history of making poor management decisions. The borrower may be unwilling or unable to make needed operational changes to correct serious weaknesses. Furthermore, the borrower may be uncooperative with the lender(s).

- Loan structure is inappropriate for the borrower's risk profile or intended use of the loan proceeds.

Supplemental Guidance: Substandard assets have a high probability of payment default or have defaulted. They typically require more intensive supervision by institution management and have the distinct possibility the lender will sustain some loss if deficiencies are not corrected. *Loss potential, while existing in the aggregate amount of Substandard assets, does not have to exist in individual assets (e.g. there may be well-secured loans with limited loss potential that are classified Substandard due to other credit factor weaknesses)*.

Doubtful

Definition: *Assets classified Doubtful have all the weaknesses inherent in assets classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.*

Supplemental Guidance: A Doubtful asset has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as Loss is deferred. Examples of pending events include mergers, acquisitions, liquidations, capital injections, lien perfection on additional collateral, collateral valuation, and refinancing. Borrowers with Doubtful loans are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. A Doubtful classification is sometimes used for loans that are proceeding to collection and involve specialized facilities in distressed industries where a high degree of uncertainty exists regarding the value of collateral. Generally, pending events should be resolved within a relatively short time and the classification adjusted based on the new information. Because of a high probability of loss, Doubtful assets will also be nonaccrual.

Examiners should not classify an entire asset Doubtful when collection of a specific portion appears probable. An example of properly using the Doubtful category is the case of an entity being liquidated. Assume a bankruptcy trustee has indicated a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the System lender. By definition, the 25 percent difference would be the only portion classified Doubtful. A proper classification of the credit would be 40 percent Substandard, 25 percent Doubtful, and 35 percent Loss.

Loss

Definition: *Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.*

Supplemental Guidance: With Loss assets, the underlying borrowers are often in bankruptcy, have suspended debt repayments, or have otherwise ceased normal business operations. Once an asset is classified Loss, there is little prospect of collecting either its principal or interest within a reasonable time period and a chargeoff is recorded. When uncertainty regarding lien position rather than the value of the collateral is a problem, a less severe classification may be appropriate. However, institutions should not maintain an asset on the balance sheet if realizing its value would require long-term litigation or other lengthy recovery efforts. In those cases, a chargeoff should be recorded with the possibility of a recovery in future periods. As discussed in FCA's High-Risk Asset Accounting and Reporting guidance, FCA Regulation 621.5(c) requires institutions to charge off loans, wholly or partially, as appropriate, at the time they are determined to be uncollectible. In addition, FCA Regulation 621.5(d) requires institutions to charge off such amounts as directed by FCA if the amount determined to be uncollectible by the institution is different from the amount determined by FCA.

Delaying loss recognition due to the remote possibility that a restructure may occur is not consistent with the definitions contained in the UCS or generally accepted accounting principles. It is expected that an institution and borrower will arrive at a formal restructure agreement within a reasonable time following the start of negotiations. Normally, formal written agreements for restructuring should result within 6 months of the start of negotiations. Negotiations continuing for a significantly longer period without a final written agreement between the institution and the borrower may indicate the possibility of restructuring is remote. In these situations, the under-secured portion of the loan would typically be considered a known loss and would be charged off.

Refer to the *Doubtful and Loss UCS Classifications* section in FCA's FAQs About Risk Identification for additional guidance on using these classifications.

The 5 C's of Credit

The following provides a summary description and evaluative considerations for each of the five primary credit factors, commonly referred to as the 5 C's of credit (capacity, capital, collateral, character, and conditions). The evaluative considerations, in particular, should serve as a useful reference for examiners when examining and classifying assets.

Capacity

Capacity refers to the borrower's ability to repay debt obligations. FCA regards repayment capacity as the most important quantitative credit factor. Evaluating repayment capacity starts with identifying the primary or intended repayment source and determining its reliability as a sustainable source of cash. The primary repayment source should be cash from normal operations or other recurring and reliable sources. This requires an analysis of cash flow (sources and uses of cash) and earnings. Projections should be realistic in relation to past performance, but should also reflect any significant changes in operations or economic conditions expected over the loan term. Absent such changes, cash flow and earnings history should evidence that future repayment capacity is sufficient to meet all obligations, including normal living expenses and income taxes, with excess sufficient for capital replacement and contingencies. The borrower's repayment history should also be considered in this evaluation. The following provides additional, more specific evaluative considerations:

- Are projections reasonable in relation to historical performance? Projections should typically be analyzed in relation to historical performance unless the operation or industry has undergone significant changes.

- Is projected income and expense information realistic and based on reliable sources (e.g., U.S. Department of Agriculture reports, university studies, published industry experts)?

- Are current commodity prices and long-term averages used appropriately when evaluating short-term and multi-year credit actions? Using current prices when assessing capacity on operating loans is a reasonable practice, while a long-term average price may be more appropriate on intermediate and long-term loans.

- How does the accounting and evaluation of hedging gains and losses, inventory valuation adjustments, and extraordinary gains and losses impact repayment capacity? The lender should understand the producer's hedging and risk management strategies and related accounting. For instance, producers using mark-to-market accounting for their hedging activity can significantly distort their "true" repayment capacity.

- Does the capacity analysis include appropriate adjustments to understand the operation's "true" earnings? Most traditional farm operations use cash basis accounting, which may distort (either positively or negatively) the operations true earnings performance. Depending on the size, complexity, and risk of the lending relationship, credit analyses should include accrual adjustments to the financial statements to determine whether an adequate repayment margin from recurring sources exists.

- Has a sensitivity analysis been completed on repayment capacity to determine the ability to withstand income volatility? A sensitivity analysis should be required for operations undergoing significant changes or operating in distressed or extremely volatile industries. The analysis should consider the borrower's ability to withstand adversity from changes in factors such as commodity prices, input costs, interest rates, government payments, yields, and integrator contracts.

- If applicable, was a global cash flow analysis completed (i.e., an analysis of the combined cash flow of closely related entities)? A global cash flow analysis is needed to ensure the principal owner or borrower and all closely held entities have adequate cash flow to meet the consolidated debt service requirements. This analysis includes tracking the movement of owner distributions and withdrawals to determine if any entities cannot cash flow independently. It should also include an evaluation of the owner's liquid assets to determine how much support the owner is able to provide in the event of adversity.

- Does the calculation and analysis of term debt repayment capacity focus on debt service coverage ratio (DSCR), capital debt repayment capacity (CDRC), or some other similar measure? Pros and cons exist for the various ratios. The DSCR may be an appropriate measure of short-term capacity to service term debt, while the CDRC also considers the borrower's ability to cover capital asset replacement needs and restore working capital (as applicable). Regardless of the measure used, the repayment capacity analysis should address items such as:

    - Capital asset replacement needs as a debt servicing requirement, with sufficient support if omitted.
    - Working capital deficiencies, including calculation of annual working capital replacement needs as a debt servicing expense.

- Carryover debt and appropriate repayment terms as an annual debt servicing expense.
- Term debt demands based on “normalized” terms for those loans structured with little or no principal amortization.
- Living expenses and the process for determining a reasonable amount, with appropriate adjustments based on factors such as:

    - Amount of non-farm income (it is common to use non-farm income to cover living expenses).
    - Number and age of family members.
    - Credit card debt, education expenses, and insurance costs.
    - Borrower’s lifestyle, considering items such as the value of personal vehicles, value and size of house, and ownership of second homes, recreational properties, and recreational equipment.

Capital

Capital relates to a borrower’s ability to meet obligations, continue business operations, and protect against adversity and unexpected losses. The borrower’s liquidity, total assets, working capital, total equity, contingent liabilities, financial progress, and history of earnings are significant measures of a borrower's capital position. The following provides additional, more specific evaluative considerations:

Liquidity: Consider the following areas when evaluating the borrower’s liquidity:

- Is liquidity sufficient to meet financial obligations as they come due in the ordinary course of business, without disrupting normal operations? Common liquidity measures include the current ratio, quick ratio, working capital, and working capital to gross revenue ratio.

    - The current ratio is not always a good indicator of liquidity. Businesses with limited current assets and liabilities may have a strong current ratio, but lack the liquid reserves to cover short-term cash flow shortages. In addition, current liabilities (including the current portion of term debt, deferred expenses, etc.) are not always adequately reflected on the financial statement, which inflates the current ratio.

    - Working capital divided by gross revenues (or value of farm production) measures working capital in relation to the size of the business.

    - Examiners should consider how the volatility in agricultural commodity and input prices could affect working capital and gross revenues.

- Are the borrower’s liquid reserves adequate to meet cash demands for the commodities produced? Different commodities can have different liquidity needs and variations in the frequency of cash flows. For example, a dairy operation receives payment for the milk marketed twice a month, whereas a cropping operation typically markets grain and receives payments much less frequently. Therefore, the liquidity analysis should account for these variations in cash inflows relative to the timing of cash outflows. A cash flow statement is typically used in this analysis.

- For stressed industries experiencing losses, is the liquidity burn rate analyzed? This analysis will identify the number of months or operating cycles an operation can incur projected losses before exhausting its working capital.

- Does the borrower use committed lines of credit as the primary source of liquidity? Using lines of credit rather than maintaining working capital varies by industry and is common in larger operations with ready access to debt (i.e., capital markets lending). Examiners should carefully evaluate the borrower's ability to service additional debt when committed lines of credit are used as the primary source of liquidity.

Solvency: Consider the following when evaluating the borrower's solvency:

- Is the borrower's solvency sufficient to support ongoing business operations and protect against adversity? Factors to consider when analyzing solvency and balance sheet leverage include:

    - Net worth
    - Owner equity as a percentage of assets (or inversely debt-to-assets)
    - Total debt to earnings before interest, taxes, depreciation and amortization (EBITDA)
    - Quality of the borrower's assets

- What is the source of the borrower's net worth? Net worth that is derived from asset appreciation, intercompany receivables, and goodwill or other intangible assets is generally not as high quality as that derived from tangible assets and retained earnings. Changes in net worth attributable to asset appreciation are typically identified through an earned net worth analysis. This analysis should be completed if an accrual income statement is not available to determine the actual earnings generated by the operation.

Balance Sheet: Consider the following areas when evaluating a borrower's balance sheet:

- What trends exist and what are the causes of these trends?

- Are there leases, guarantees, and other off-balance sheet items that may potentially impact capital position?

- Are financial statements appropriately consolidated? Financial statements should generally be consolidated when lending to closely-held entities that are financially interdependent, liable for each other's loans, or have common ownership and control.

- How are assets and liabilities affected when a spouse has not signed on a loan? Is risk associated with commonly owned assets recognized (e.g., what assets are available in a collection scenario)?

- Are asset and liability values appropriately adjusted to reflect any discrepancies or concerns identified by the lender during the verification process? For example, values on specialized or non-typical assets (e.g., goodwill) should be adjusted if not adequately supported.

Collateral

Collateral is the security pledged on the loan. The collateral should reasonably protect the lender against loss and provide the necessary control over the borrower's equity and repayment, while leaving the borrower in a position to constructively manage the business. The type, quality, and location of collateral, as well as its ability to produce income, are relevant considerations when assessing collateral adequacy. Where applicable, the collateral must also comply with regulatory requirements. In addition, government guarantees (Farm Service Agency, Small Business Administration, USDA, state programs, etc.), Farmer Mac standby commitments, and in some instances personal guarantees add strength to the collateral position. The lender's loss exposure can be reduced by these guarantees as long as they remain valid and the guarantor has the financial capacity to honor the agreement. The following provides additional, more specific evaluative considerations:

- Do the amount, type, and quality of collateral reasonably protect the lender against loss?

- Are collateral values based on current and accurate evaluations?

- Are discounts applied to unique or specialized collateral?

- How are growing crops valued? Typically, the collateral value should be limited to the insured value for multi-peril insured growing crops. If not insured, the collateral value should be limited to the investment in the growing crop.

- Is the security interest in collateral verified and perfected (e.g., mortgage, deed of trust, Uniform Commercial Code financing statements, security agreement, etc.)?

- Were loan-to-value standards, lending caps, or other conditions met to adequately manage collateral risk?

- If unsecured, did the loan have sufficient strengths in other credit factors to reasonably protect the lender against loss? Unsecured loans should be limited to the strongest borrowers and be consistent with the loan purpose and terms.

Character

Character refers to the borrower's integrity and management ability. Responsible and cooperative management must be evident. This factor is of such significance that it can affect the weight placed on the other credit factors, particularly if the evaluation of character is negative. Analysis should include a careful evaluation of the borrower's risk, production, and financial management. Equally important is the borrower's willingness to comply with loan conditions and work constructively with the institution as changes to the borrower's risk profile occur. As such, considerable emphasis should be placed on the institution's past relationship with the borrower. The following provides additional, more specific evaluative considerations:

Risk Management: Risk management refers to the borrower's ability to mitigate production and financial risks. Key items to consider include:

- Are the borrower's risk management practices commensurate with the size and complexity of the operation? Common risk management practices include using commodity insurance programs, forward contracting, hedging, and other tools to manage revenue and control input costs.

- Is the borrower diversifying operations and marketing through multiple channels or outlets to reduce reliance on a single market or counterparty?

Production Management: Production management refers to the borrower's overall production practices and capabilities. Key items to consider include:

- Does the borrower use modern and proven production practices and seek ways to improve operational efficiency?

- Is actual production comparable to peers and industry averages?

- Does the borrower have proven production experience and a commitment to remain knowledgeable of industry best practices (training, expert assistance, etc.)?

- Does the borrower adequately maintain and update capital assets as needed to support ongoing operations?

Financial Management: Financial management refers to the borrower's ability to plan, monitor, and control their monetary resources. Sound financial managers can remain profitable in most operating environments and minimize losses during industry down cycles due to their ability to adjust to changing conditions. Key items to consider include:

- Has the borrower demonstrated the ability to generate sustained positive financial results? The borrower should demonstrate the ability to manage liquidity and debt at reasonable levels. The ability to effectively manage and adjust expenses (e.g., living expenses) and capital expenditures is also important, particularly during an industry down cycle.

- Has the borrower demonstrated the ability to make scheduled payments, comply with loan terms and conditions, and cooperate with the lender?

- Is management's experience and depth, including any recent or planned management changes, sufficient for the operations being financed?

- Are the quality and completeness of financial statements commensurate with the size, complexity, and risk presented by the operation? Are financial projections reasonable and consistently achieved?

- Do the borrower's credit bureau score and report reflect adequate credit history? Credit bureau scores and reports may evidence the borrower's repayment history or identify emerging issues related to borrower financial management practices (e.g., increased consumer debt for family living or financing the operation).

- Has a business plan been developed that includes reasonable projections and contingency strategies?

Conditions

Conditions are items that help the lender control risk in loans. Conditions should be commensurate with the loan type, purpose, and overall risk in the account. Examples include controls on loan amounts and proceeds, structure, repayment terms, interest rate, and covenants. The loan conditions should be constructive in amount and purpose and practical as to repayment terms for both the borrower and lender. Conditions such as personal liability, additional collateral, and insurance should be required as each situation warrants. The following provides additional, more specific evaluative considerations:

- Are loan maturities consistent with the loan purpose, useful life of the asset financed, and regulatory requirements?

- Are repayment plans and schedules well defined and consistent with the planned repayment source? Repayment plans primarily dependent on refinancing are generally inappropriate and increase risk to the lender.

- Is the loan structured to require repayment consistent with assets financed? Term loans that are structured with limited or no principal amortization can lessen borrower discipline in repaying the debt and result in increased credit risk to the lender. Furthermore, if borrower repayment capacity is measured against lenient repayment terms, the resulting analysis may inappropriately overstate the borrower's ability to repay the debt.

- Are loan conditions consistent with institution and industry guidelines related to financing specialized capital items, unsecured lending, or out-of-territory lending?

- Are financial, reporting, and other covenants appropriate relative to the risk, size, and complexity of the borrower's operations?

- Does the borrower have a history of complying with loan terms and conditions, including repayment terms and covenants? If not, what are the causes of non-compliance? Were any resulting terms and conditions achievable, while also mitigating the institution's risk?