Module: Assets
Section: Asset Classifications
EM-320

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Introduction

Farm Credit System (System) institutions use asset quality classifications to identify and disclose risk in the loan portfolio. The classification system predominantly used by System institutions is the Uniform Classification System (UCS). UCS classifications express the degree of risk of nonpayment in individual assets. As discussed in the Loan Portfolio Management section of this module, effective risk identification is essential to the safe and sound operation of System institutions.

This section provides examiners with guidance for classifying loans and loan-related assets for the purpose of verifying the effectiveness of management's risk identification process. The section includes a description of the UCS, the credit factors analyzed to assign a UCS classification, and a listing of procedures that can be used to examine this area.

Examination Objective

Determine if management is adequately identifying risk in the loan portfolio through the UCS or an alternative system of risk measurement.

UCS Classifications and Standards

Two elements are necessary to develop classification results into meaningful data: clear, well-understood classification definitions, and uniform application of the definitions. The UCS provides the classification definitions necessary to develop meaningful data on the quality of the loan portfolio.

While the UCS is primarily used to evaluate the quality of the loan portfolio, it can also be used to assess risk in other property owned and the investment portfolio. Other property owned is considered a Substandard asset, although generally not assigned a specific credit classification. In some instances, however, it may be appropriate to classify a portion of such property Doubtful or Loss to reflect a high possibility of loss or a known loss, respectively. In contrast, investments held by System institutions are typically of high quality, are readily marketable, and would normally be classified Acceptable. Nevertheless, if concerns exist as to the ultimate collectibility of an investment, such as Federal Funds sold to a troubled financial institution, it may be appropriate to criticize the investment. The examination of investments is further discussed in the Investments section of this module.

UCS credit classifications are assigned on the basis of risk and include the following five categories: Acceptable, Other Assets Especially Mentioned, Substandard, Doubtful, and Loss. Assets classified Substandard, Doubtful, and Loss are considered adversely classified assets; assets classified less than fully Acceptable (i.e., Other Assets Especially Mentioned, Substandard, Doubtful, and Loss) are considered criticized assets. Assets may also be assigned more than one classification when portions of the asset clearly meet different classification standards. A general description and application of each classification category is provided below.

Acceptable

These are noncriticized assets of the highest quality. They do not fit into any of the other categories. This category is also used to classify the guaranteed portion of government-guaranteed loans. Upon determination that the loan guarantee constitutes an enforceable contract, the guaranteed portion is classified Acceptable. The amount considered covered by the guarantee, for classification purposes, is the total outstanding balance (principal and interest) of the loan multiplied by the guarantee percentage. Criticism or adverse classification of guaranteed portions of loans may occur when enforceability of the guarantee contract is jeopardized. The remaining balance, or nonguaranteed portion, should be classified according to the standard classification criteria.

Other Assets Especially Mentioned (Special Mention)

Assets in this category are currently protected but are potentially weak. These assets constitute an undue and unwarranted credit risk, but not to the point of justifying a classification of Substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific asset.

Special Mention assets have potential weaknesses that may, if not checked or corrected, weaken the asset or inadequately protect the institution's position at some future date. Assets in this category may include loans that have deviations from prudent lending practices, and/or those subject to economic or market conditions that may, in the future, affect the borrower. An adverse trend in the borrower's operations or an imbalanced position in the balance sheet that has not reached a point where repayment is jeopardized may best be handled by this classification. This category should not be used to list loans that bear risks usually associated with the particular type of financing.

Any type of loan, regardless of collateral, financial stability, and responsibility of the borrower, involves certain risks. A loan secured by accounts receivable has a certain risk, but to criticize such a loan it must be evident that risk is increasing beyond the level at which the loan originally would have been granted. A rapid increase in receivables without the lender knowing the cause, concentrations that lack proper credit support, lack of on-site appraisals or inspections, or other similar matters could lead the examiner to question the quality of the receivables and possibly classify the loan as Special Mention. Loans in which actual, rather than potential weaknesses are evident and significant should be considered for more severe classification.

Substandard

These assets are inadequately protected by the repayment capacity, equity, and/or collateral pledged. Assets so classified must have a well-defined weakness or weaknesses that could hinder normal collection of the debt. They are characterized by the distinct possibility that the lender will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard assets, does not have to exist in individual assets.

Doubtful

Assets classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high. Because of certain important, specific, pending factors that may work to the advantage or disadvantage of the assets, classification as Substandard or Loss is deferred until a more exact status can be determined. Pending factors might include a proposed merger, acquisition, liquidation, capital injection, perfecting liens on additional collateral, or refinancing plans.

Examiners should avoid classifying an entire credit Doubtful when collection of a specific portion appears highly probable. An example of proper utilization of the Doubtful category is the case of an entity being liquidated, where the trustee-in-bankruptcy has indicated a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the System lender. By definition, the only portion of the credit that is Doubtful is the 25-percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent Substandard, 25 percent Doubtful, and 35 percent Loss.

Loss

Assets classified Loss are considered uncollectible and of such little value that their continuance as bookable 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 effected in the future.

Delaying the recognition of losses due to the remote possibility that a restructure will occur is not considered consistent with the definitions contained in the UCS or generally accepted accounting principles. It is expected that an institution and the borrower will arrive at a formal agreement within a reasonable period of time following the start of negotiations to restructure. 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 indicates that the possibility of restructuring is remote. In these situations, the under-secured portion of the loan would be considered a known loss and should be charged off.

In cases where the entire loan is considered a loss, the portion of the loan equivalent to the stock outstanding may be considered Acceptable. If the stock is not to be applied on the loan or impairment of the institution's capital is involved, the Regional Director should be contacted for guidance.

Credit Factors

Accurate credit classification requires an analysis of the asset relative to the five credit factors. The five credit factors, or the five C's of credit, which the examiner evaluates in classifying loans are: capacity, capital, collateral, character, and conditions. The relative weight assigned to each credit factor varies with the circumstances of the individual situation.

The following provides a general description of each credit factor.

Capacity

Capacity refers to the borrower's ability to repay. The determination of repayment capacity requires an analysis of cash flow, sources of repayment, and earnings history. Cash flow projections should be realistic in relation to past performance and should identify the source(s) of repayment. The source of repayment should be assessed to ensure repayments are expected from normal operations or from other recurring and reliable sources. Earnings history should evidence that future income is sufficient to meet all obligations, including normal living expenses, with some left for capital replacement and contingencies. Points to consider include:

- Historic earnings performance;
- Repayment history;
- Stable and reliable income;
- Sources of repayment;
- Projected earnings; and
- Cash flow projections.

Capital

Capital relates to the ability to meet obligations, continue business operations, and protect against undue risk. The applicant's total assets, working capital and liquidity, amount of equity, contingent liabilities, financial progress, and history of earnings to date are significant measures of a borrower's capital position. Points to consider include:

- Asset/liability structure;
- Working capital and liquidity;
- Owner equity position;
- Financial trends; and
- Earned net worth as a percent of total net worth.

Collateral

Collateral is the security pledged on the loan. Where applicable, the collateral amount taken must comply with regulatory requirements--it should reasonably protect the lender, provide the necessary control of equity and repayment, and leave 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 factors used to assess collateral adequacy. In addition, personal or entity liability in the form of guarantors or partial guarantors may provide added strength in extending credit. Sufficient analysis should be made of credit factors relevant to such guarantors or partial guarantors to ensure they can reasonably provide support for the loan. Points to consider include:

- Reasonable lender protection;
- Perfected security interest;
- Current and accurate evaluation reports;
- Availability of additional collateral;
- Collateral risk (potential to decline in value); and
- Income producing and debt servicing ability of the collateral relative to its current market value.

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 management of finance and operations. Points to consider include:

- Realistic production and financial goals;
- Adequate financial records;
- Proven management experience;
- Borrower's marketing plan/approach; and
- Compliance with loan terms.

Conditions

Conditions include the amount of loan, use of proceeds, and loan terms over which the lender has direct control. The conditions of a loan should be constructive in amount and purpose and practical as to repayment terms for both the borrower and lender. Conditions such as loan agreements, personal liability, additional collateral, and insurance should be required as each situation warrants. Points to consider include:

- Prudent and productive loan purposes;
- Past experience in fulfilling conditions;
- Loan maturities coinciding with the purpose of the loan;
- Proper structure of loans financing specific major capital items; and
- Appropriate repayment plans/schedules established consistent with the source of repayment.

Internal Control Considerations

To ensure the board of directors receives reliable information on the quality of the portfolio, the board should establish adequate policies and procedures governing the use and implementation of the UCS or an alternative system of risk measurement. In addition, boards should utilize their internal credit review process to determine the reliability of management's asset classifications and to monitor compliance with related policies and procedures. Boards may also utilize their Management Information System (MIS) to track and report asset classification statistics on a periodic basis.

Examination Procedures

Asset classifications are examined to determine if the institution is adequately identifying risk in the portfolio. As such, this examination activity is part of the overall evaluation of an institution's risk identification process, which was discussed in the Loan Portfolio Management section of this module. This requires considerable coordination between the examiners involved in Loan Portfolio Management and those involved in classifying assets to ensure examination objectives are achieved in an effective and efficient manner.

The examination scope in this area is determined by considering several factors, such as: the adequacy of policies, procedures, and internal controls, including the internal credit review process; previous examination findings; the condition and trends in the loan portfolio; economic conditions; and the financial condition and performance of the institution. Based on a review of these factors, individual assets can be selected to validate the reliability of management's asset classifications. It is essential that the selection of loans to be examined focuses on risk and achieves stated examination objectives.

The adequacy of management is probably the most important factor to consider in selecting loans for examination. For instance, if adequate policies and procedures directing and controlling the classification of assets are not in place, the reliability of the institution's risk identification may be in question and additional testing of assets necessary. In contrast, the board and management may have adequate policies, procedures, and internal controls, and demonstrate the capacity and willingness to promptly identify and correct problems. Generally, the more reliable the institution's risk identification processes, the fewer number of assets, if any, which need to be examined.

While on site, the loan classification sample should be reevaluated periodically by the examiner-in-charge (EIC) to determine if the sample remains appropriate, or if the sample should be expanded or reduced. This determination should be based on completion of sufficient work to support a conclusion.

In developing conclusions, examiners should focus on the overall reliability of the institution's asset classifications, rather than on individual assets which were misclassified or improperly graded. Examiners should also consider whether management adequately identified and addressed risk in those loans which were misclassified or improperly graded. In addition, examiners should consider the overall effectiveness of the internal credit review process in reporting reliable asset classifications. If significant weaknesses are disclosed, the examination should concentrate on identifying the underlying causes and their effects to ensure that corrective action is achieved.

The following list of procedures is provided to assist examiners in completing this examination activity. Consistent with risk-based examination principles, examiners should add, delete, or modify procedures as needed based on the particular circumstances of the institution.

Examiners should also coordinate their examination activities with other members of the examination team and the EIC. Emphasis should be on identifying how examination findings in other areas impact the review, ensuring sufficient work is completed to support conclusions, and avoiding duplication of examination effort.

1. In coordination with the examiner assigned loan portfolio management, review the institution's policies and procedures to determine if they include adequate direction and guidance regarding the classification of assets. Consider factors such as:

    a. Consistency with the definitions set forth in the UCS. If not duplicative of the UCS, the classification or grading system should clearly define degrees of risk;

    b. Discussion of classification definitions and their application;

    c. Responsibilities for assigning, reviewing, changing, and reporting asset classifications;

    d. Frequency and scope of reviews to determine the appropriateness of asset classifications; and

    e. Use of the internal credit review process to determine if classifications are reliable and policies and procedures are appropriately applied by lending staff.

2. Review the results of the internal credit review process to determine if the institution is adequately classifying or grading assets.

3. Examine a sample of assets in each classification to determine if the institution is properly identifying and reporting classifications or grades.

4. Conduct loan discussions with the assigned account officer to verify facts and to obtain additional information on the loan(s).

5. Document the examination of individual loans on FCA 3005, Asset Classification Summary.

6. Summarize findings to arrive at an overall conclusion regarding the institution's identification and reporting of risk through asset classifications.

7. Discuss tentative conclusions and examination findings with examiners assigned areas which may be affected by the findings, particularly those assigned loan portfolio management, allowance for loan losses, internal controls, and financial condition.

8. Discuss items of concern, scope of work performed, and conclusions with the EIC and with the appropriate institution manager. Obtain a response regarding the cause(s) of deficiencies or weaknesses and anticipated corrective actions.

9. Prepare a leadsheet or other summary document to provide workpaper support for the work performed and the conclusions reached.