

Advisory: Prudent Management of Agricultural Lending During Economic Cycles

Financial institutions, and community financial institutions in particular, continue to demonstrate a strong commitment to agricultural financing. From 2010 to 2015, the U.S. agricultural industry enjoyed robust economic conditions driven by historically high commodity prices. In general, this environment generated wealth and surplus working capital for agricultural producers and sound asset quality for financial institutions focused on agricultural lending. According to the United States Department of Agriculture (USDA), net farm income reached an all-time high of \$123.4 billion in 2013. However, by 2016, it fell by roughly one-half to \$61.5 billion. The USDA forecasts 2019 net farm income at \$88.0 billion, lower than the 2000-2018 average.¹

Thus far, the positive effects of the 2010-2015 “boom” period have buoyed the performance of financial institutions focused on agricultural lending; generally, delinquency and loss rates remain low, and earnings have been sufficient to support growth and augment capital. That said, cash flow margins for agricultural borrowers have become increasingly pressured by changes in supply and demand factors, poor weather conditions, and agricultural policy factors. Row crop operating expenses have risen while soybean, corn, and wheat prices have fallen. Livestock sectors have also been challenged, especially dairy farming and cattle feeding. Farm working capital levels have deteriorated, debt balances have increased, and debt repayment capacity has constricted.

Despite the difficult agricultural environment, farm real estate and equipment values have remained fairly resilient. Restructuring carryover debt has been a reasonable approach for borrowers with strong equity positions. However, given strained cash flow, debt service has been challenging for borrowers with even moderate levels of term indebtedness. As headwinds facing the agricultural economy persist, insured institutions must be prepared for agricultural borrowers to face financial challenges by employing appropriate governance, risk management, underwriting, and credit administration practices.

Prudent Credit Risk Management for Agricultural Lending

All financial institutions should maintain capital, reserves, and risk management systems commensurate with their credit activities and exposures. The Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines), promulgated pursuant to Section 39 of the Federal Deposit Insurance Act, indicate that all insured institutions should have, among other things, a system of effective internal controls, appropriate loan documentation practices, prudent underwriting practices, and a system of ongoing credit and asset quality reviews.

Risk analysis that centers on a borrower’s cash flow and repayment capacity and that does not overly rely on collateral values is crucial. For most agricultural loans, primary repayment sources include cash flows from anticipated crop production and livestock operations. Therefore, assessment of the timing and level of projected cash flows over a reasonable period, and ensuring that cash flows match the purpose and terms of a loan, are keys to effective credit analysis. Sound practices include evaluating baseline cash flows under significantly modified projections for key variables, such as input costs, interest rates, and sale prices.

¹ USDA Economics Research Service, Highlights From the August 2019 Farm Income Forecast, available at <https://www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/highlights-from-the-farm-income-forecast/>. Net farm income average for 2000-2018 is \$90.1 billion.

Often, smaller farms and ranches rely on principals' personal wealth and resources, including off-farm wages, to support operations. Therefore, analysis of a borrower's overall financial status, including credit history and use of nonbank credit, is an important part of assessing a borrower's willingness and ability to repay their debts. A borrower's management abilities and experience are also part of the equation.

In addition to primary cash flow analysis, consideration of secondary repayment sources and collateral support levels is important. For example, a borrower's informed use of crop insurance and appropriate hedging products can reduce risks to the farming operation and the lending institution. Properly administered credit enhancements, such as government guarantees, can also reduce credit loss exposures.

Managing risk over the life of a loan includes: carefully documenting all lien perfections and other loan instruments; closely overseeing sale proceeds; conducting timely, independent collateral inspections; and developing a process for monitoring collateral values. A continuous credit grading program can help management identify credit risk early and take preemptive steps to prevent further deterioration. Assigning initial credit grades, ensuring timely grade changes, and assessing the adequacy of the Allowance for Loan and Lease Losses in light of grade changes are vital.

Concentrations of credit to individual borrowers or segments of the agricultural industry warrant careful identification and management. Effectively managing credit concentrations and complying with statutory lending limits does not entail automatically refusing credit to sound borrowers because of their particular business segment or geographic location. Instead, the creditworthiness of individual borrowers, an institution's risk appetite and tolerance, and the adequacy of risk management practices remain critical loan decision factors. Agricultural lending policies that detail the board's risk tolerances and include appropriate procedures for identifying, monitoring, and controlling concentrations are practices crucial to effective lending.

Lastly and importantly, ensuring that the lending function is properly staffed with well-trained individuals to perform the risk management practices listed above can help limit deterioration in credit quality, even in a challenging underwriting and collection environment.

Developing Appropriate Workout Strategies for Agricultural Credits

During the agricultural crisis of the 1980s, the financial condition of many agricultural borrowers deteriorated due to depreciating land values, high interest rates, and volatile commodity prices. Despite the challenging conditions, many farm operators remained creditworthy financial institution customers who demonstrated a willingness and capacity to repay their debts. In situations where borrowers struggled to make scheduled payments, many financial institutions and borrowers found mutually beneficial ways to restructure credit facilities.

The FDIC believes prudent loan workouts can take many forms, including the renewal or modification of loan terms, or the restructuring of credit facilities with or without concessions. Appropriate loan restructures can help farm customers negotiate adverse business conditions and allow additional time for borrowers to stabilize operations. Credits that are restructured consistent with sound banking, supervisory, and accounting practices can mitigate the risk of loss to the financial institution.

From a supervisory perspective, restructured loans to farming operations with the documented ability to repay debts under reasonably modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined. Further, an institution that implements prudent loan workout arrangements after performing a comprehensive review of a borrower's financial condition will

not be subject to criticism for engaging in these efforts, even if the restructured loans have weaknesses that result in adverse classification.

Capital

The Guidelines set the standards used by the FDIC to identify and address problems at FDIC-supervised financial institutions before capital becomes impaired. Management's careful and proactive consideration of capital levels through cycles, and having and following a plan to monitor and augment capital as needed, can allow the institution to better weather periods in which adverse financial results are experienced.

Resources

Principles in the following documents are readily adaptable to lending relationships in the agricultural sector:

- Appendix A to Part 364 – Interagency Guidelines Establishing Standards for Safety and Soundness. ([Appendix A Part 364](#))
- Risk Management Manual of Examination Policies – Section 3.2 Loans - Agricultural Lending, pages 24-28 ([Exam Manual - Section 3.2](#))
- Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers, February 12, 2010 ([FIL-5-2010](#))
- Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts, October 30, 2009 ([FIL-61-2009](#))
- Interagency Statement on Meeting the Needs of Creditworthy Borrowers, November 12, 2008 ([FIL-128-2008](#))

The continued availability of credit is vital to the success of our nation's farming and livestock operations. Given the potential volatility in the agricultural sector, prudent risk management practices are necessary to ensure that agricultural credits are originated and administered consistent with sound lending standards. Community financial institutions in particular have demonstrated a strong commitment to agricultural financing, and the FDIC encourages financial institutions to continue making prudent loans to creditworthy farmers and ranchers.

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