Prudent Management of Agricultural Credits Through Economic Cycles

The U.S. agricultural industry has benefited from a decade of overall strong profitability, with several years of high commodity prices and improving livestock margins. Although crop prices have recently declined from record levels, they remain above historical averages. The generally strong financial performance of the agricultural sector is reflected in the robust credit quality reported by the nation's agricultural lenders, with median agricultural loan delinquencies and chargeoffs near the lowest levels since the early 1970s. Profitability within the industry has improved the overall equity and working capital positions of many agricultural producers and related small businesses, and the USDA reports that the overall farm debt-to-asset ratio remains low at approximately 11 percent.

Notwithstanding the current strength of the agricultural industry, the USDA forecasts higher borrowing costs, moderation in the growth of farmland values, and a decline in net farm income (of approximately 27 percent) in 2014.[1] Additionally, the industry remains susceptible to financial shocks from various sources, including weather-related events, market volatility, geopolitical risks, and declining commodity prices. Therefore, the implementation of sound risk-mitigation strategies is both a regulatory expectation and a prudent banking practice. The FDIC is re-emphasizing supervisory expectations by updating and replacing FIL-85-2010, titled *Prudent Management of Agricultural Credit through Farming and Economic Cycles;* FIL-85-2010 is hereby rescinded.

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. Risk analysis should center on a borrower's cash flow and repayment capacity and not rely unduly on collateral values. For most agricultural loans, primary repayment sources include cash flows from anticipated crop production and livestock operations. Therefore, credit analysis should assess the timing and level of projected cash flows over a reasonable period and ensure that cash flows match the purpose and terms of a loan. Sound practices include evaluating baseline cash flows under significantly modified projections for key variables, such as input costs, interest rates, and sale prices.

Often, smaller farms and ranches rely on the 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. This information should be considered with other subjective factors, such as a borrower's management abilities and experience.

In addition to cash flow analysis, lenders should analyze secondary repayment sources and collateral support levels. For example, a borrower's informed use of crop insurance and appropriate hedging products can reduce risks to the farming operation and the

[1] U.S. Department of Agriculture, Economic Research Service, Farm Sector Income and Finances, February 11, 2014, available at http://www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances.aspx.

lending institution. Properly administered credit enhancements, such as Farm Service Agency guarantees, can also reduce credit-loss exposures. Although risk mitigation products and programs can be beneficial, lenders should focus the credit analysis on a borrower's financial strength and repayment ability. Such analysis should be sensitive to evidence of speculation in agricultural land prices and commodities that may influence the market. Management should document all lien perfections; conduct timely, independent collateral inspections; and develop a process for monitoring collateral values to manage risk over the life of a loan.

Concentrations of credit to individual borrowers or segments of the agricultural industry should be identified and carefully managed. The FDIC expects institutions to effectively manage credit concentrations and comply with statutory lending limits; however, this does not mean lenders should automatically refuse credit to sound borrowers because of their particular business segment or geographic location. Instead, lenders should base loan decisions on the creditworthiness of individual borrowers, an institution's risk appetite and tolerance, and the adequacy of risk management practices. These practices should include agricultural lending policies that detail the board's risk tolerances and include appropriate procedures for identifying, monitoring, and controlling concentrations.

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 bank 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 bank.

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.

The following issuances convey prudent banking principles that can be readily adapted to lending relationships in the agricultural sector:

- 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 banks 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.