



FEDERAL RESERVE BANK *of* KANSAS CITY

November 7, 2011

Attention: Chief Executive Officer of Each Tenth District State Member Bank

Subject: Supervisory Expectations for Risk Management of Agricultural Credit Risk

In Brief: This letter applies to all banking organizations with significant exposure to agriculture-related credit risk, including those with \$10 billion or less in consolidated assets. The guidance outlined in the letter is intended to serve as a reminder of the key risk factors in agricultural lending and supervisory expectations for a banking organization's risk-management practices.

Highlights: This guidance is being issued largely in response to recent market developments, but the risk-management principles are broadly applicable irrespective of agricultural market conditions. The letter highlights several examples of recent market issues that have increased volatility and risk, and also describes supervisory expectations for credit risk management and underwriting practices. The letter addresses factors that examiners will consider in evaluating individual agriculture-related credits and the adequacy of a banking organization's practices to monitor a borrower's capacity to repay given uncertain events. These concepts are based on existing guidance found in section 2140 of the Federal Reserve's Commercial Bank Examination Manual on "Agricultural Loans". Expectations for the level of sophistication of risk-management systems will vary based on the specific risk characteristics, complexity and size of a bank's exposure to agriculture. In general, there should be higher expectations around risk-management systems for banks with significant exposures to one or several agricultural sectors.

Attachment SR Letter 11-14: Supervisory Expectations for Risk Management of Agricultural Credit Risk

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Internet: The Commercial Bank Examination Manual is accessible via the Federal Reserve Bank of Kansas City's public website at <http://www.kansascityfed.org/banking/regulations/safety-and-soundness.cfm>.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 11-14

October 26, 2011

**TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK**

SUBJECT: Supervisory Expectations for Risk Management of Agricultural Credit Risk

Applicability to Community Banking Organizations: This letter applies to all banking organizations with significant exposure to agriculture-related credit risk, including those with \$10 billion or less in consolidated assets.

This supervisory guidance is intended to serve as a reminder to banking organizations¹ and supervisory staff of the key risk factors in agricultural lending and supervisory expectations for a banking organization's risk-management practices. While this guidance is being issued largely in response to recent market developments, the risk-management principles are broadly applicable irrespective of agricultural market conditions.

Farm producers have experienced strong profitability over the past three years, and their use of debt overall remains relatively low. While these factors have generated optimism for the future viability of agricultural producers, risk in the agricultural sector has also increased due to volatility in agricultural commodity prices, farmland values, and farm production costs. This volatility heightens the importance of appropriate risk-management and capital planning² practices at banking organizations with significant exposures to the agricultural sector. Farm production loans and loans secured by farmland real estate are generally performing well, but abrupt and adverse changes in market conditions can substantially affect a bank's ability to withstand a prolonged market downturn. Past downturns in the agricultural sector have resulted in borrower defaults and a significant reduction in collateral values.³ Accordingly, a bank's risk-management and capital planning practices should be sufficiently robust to assess the level of

¹ For purposes of this guidance, banking organizations include state member banks, bank holding companies, and savings and loan holding companies.

² As discussed in SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," an effective capital planning process requires a banking organization to assess the risks to which it is exposed and its processes for managing and mitigating those risks, evaluate its capital adequacy relative to its risks, and consider the potential impact on its earnings and capital base from current and prospective economic conditions.

³ See, for example, SR letter 84-16, "Farm and Agricultural-Related Loans."

agriculture-related credit risk and the adequacy of a bank's capital to withstand potential future market and economic distress.

Therefore, the following discussion provides an overview of current and potential agricultural market issues and risk ramifications that banking organizations and supervisory staff should consider in assessing the adequacy of the risk-management practices and capital needs for a banking organization's exposure to agriculture-related risks. This supervisory guidance also addresses factors that examiners should consider in evaluating individual agriculture-related credits and the adequacy of a banking organization's practices to monitor a borrower's capacity to repay given uncertain events. These concepts are based on existing guidance in section 2140 of the Federal Reserve's *Commercial Bank Examination Manual* on "Agricultural Loans."

Market Issues and Risk Ramifications

Prolonged and abrupt declines in farm income, brought about by negative movements in commodity prices and/or increased production costs, could have serious ramifications for the repayment ability of previously sound farm borrowers and could result in substantial declines in farmland collateral values. Highly leveraged farm borrowers or those that are in weakened financial condition would be most vulnerable to abrupt or prolonged financial distress.

Banks should monitor a number of market factors in order to manage and control the risk of their agriculture-related loan portfolio (including collateral values for farmland) and determine the repayment ability of individual farm borrowers. These factors include:

- ***Agricultural commodity prices.*** These prices have experienced unusually large swings over the past several years.
- ***Production costs.*** Volatility in costs for labor, feed, fertilizer, seed, land rent, and machinery and equipment may challenge farm operators' ability to effectively manage operating profit margins.
- ***Farmland values.*** Land values, particularly in the central United States, have surged to record highs over the past several years. Capitalization rates for farmland, particularly cropland, appear to be well below historical norms and may reflect overly optimistic long-term expectations. An abrupt increase in interest rates, coupled with a decline in farm income, could trigger an increase in capitalization rates, thereby lowering farmland values.
- ***Global market issues.*** Global supply and demand imbalances can adversely affect commodity prices and the cost of production. For example, weather events, economic conditions, and numerous other factors can impact global supply as well as demand and place downward pressure on farm income. Producers of ethanol and other biofuels may be adversely affected by the volatility in oil, corn, and other commodity prices.

Supervisory Expectations for Credit Risk Management and Underwriting Practices

The potential for volatile market conditions and risk factors raises the importance of ensuring that agricultural banks have in place appropriate risk-management programs and prudent lending standards. A key component of a sound risk-management program is the

linkage between an analysis of market conditions and an agricultural bank's risk-management and capital planning practices. The range and extent of market analysis may vary depending on the composition of the bank's portfolio and overall risk exposure. The goal of this analysis should be to provide management and the board of directors with sufficient information on current market conditions, factors that could influence changes to market conditions, and possible events that could significantly change near- and long-term market conditions. At a minimum, banks with significant agricultural exposure should have established risk-management practices that address the following:

- ***Assessment of the Borrower's Creditworthiness.*** A bank should conduct a thorough analysis of a borrower's creditworthiness, including assessments of the borrower's projected income and expenses compared to actual results, working capital adequacy, capital expense analysis, reliability of supplementary sources of income, and cash flow stress test analysis. Current borrower financial information is essential to the bank's ability to evaluate the borrower's creditworthiness and leverage. A successful agriculture-related business should exhibit strong repayment ability and risk analysis, liquidity, solvency, collateral, credit management, profitability, and management performance.
- ***Assessment of the Borrower's Cash Flow.*** In volatile markets, a highly leveraged borrower may not have the necessary cash flow to properly service the debt according to the loan terms. By reviewing the borrower-prepared cash flow statements, the bank should be able to identify potential repayment ability problems, calculate key cash flow ratios, and assess the ability of the business to handle risk and uncertainty. Risk and uncertainty due to commodity prices, production, and weather are prevalent characteristics of most farm operations and should be explained in the cash flow projections. A sensitivity analysis that determines a farm operation's ability to withstand risk and uncertainty is useful in analyzing cash flow projections. While there is a broad spectrum of agricultural activities (e.g., grain, livestock, and fruit), there are some key elements of sound financial analysis that should be applied to all situations. These elements include
 - Reviewing the reasonableness of budget assumptions and projections for yield, weight gain, production costs, and commodity prices;
 - Comparing these projections with actual performance results;
 - Assessing the impact of capital expenditures; and
 - Evaluating significant changes in the borrower's balance sheet structure.
- ***Underwriting Standards.*** A bank should periodically review its underwriting standards to ensure loan policies do not become outdated and ineffective. The frequency and depth of the review will depend on circumstances specific to each institution, such as growth expectations, competitive factors, economic conditions, and the bank's overall financial condition. Planned changes to a bank's lending function or business plan should prompt a modification to lending policies. The appropriateness of minimum debt-service-coverage ratios and maximum loan-to-value ratios should be assessed. Significant criticisms and recommendations made during recent audits and examinations should also be considered during the updating process.

- ***Credit Administration and Controls.*** A bank should have appropriate policies and controls to monitor and segregate agricultural carryover debt. Bank management should understand the fundamental causes of carryover debt. Carryover debt resulting from the borrower’s inability to generate sufficient cash flow from sales to repay the current cycle’s production loans generally reflects a well-defined credit weakness. The identification of a troubled borrower does not, however, prohibit a banker from working with the borrower. When carryover debt arises, the bank should confirm the reasons for the carryover debt (e.g., weaknesses in a borrower’s financial condition or operations, inappropriate credit administration on the bank’s part, a poor marketing plan, or adverse weather conditions), as well as the viability of the borrower’s operation so that an informed decision can be made on whether debt restructuring is appropriate. The restructured debt should generally be on a term basis and require clearly identified collateral, a reasonable amortization period, and payment amounts based on realistic expectations.
- ***Loan Structure.*** The structure of a loan will depend on the nature of the borrower’s business. To properly structure the borrowing relationship, the bank should be able to
 - Project how the borrower will perform in the future, including likely primary and secondary repayment sources;
 - Anticipate challenges and problems that the borrower may encounter;
 - Match the type and terms of the loan to both the loan purpose and the likely repayment sources and ensure the loan is supported by sufficient cash flow from the expected repayment source;
 - Develop a set of loan agreement covenants that protects the bank for the term of the loan; and
 - Secure the credit facility with collateral and consider requiring loan support such as guarantees.
- ***Reliable Collateral Evaluations and Reasonable Collateral Margins.*** A bank should have a process in place to monitor periodically the value of collateral pledged to the debt in order to manage the risk over the life of the loan. Evidence of collateral lien perfection and timely collateral inspections should be documented in the loan file review. Evidence of declining collateral margins may signify emerging concerns over the ability of the borrower to repay and could adversely affect the bank’s collateral protection in the event of default.

Expectations for the level of sophistication of risk-management systems will vary based on the specific risk characteristics, complexity, and size of the bank’s exposure to agriculture. In general, there should be higher expectations around risk-management systems for banks with significant exposures to one or several agricultural sectors. An institution should assess the effect, if any, of its agricultural credit activities upon the institution’s overall financial condition, including capital, the allowance for loan and lease losses, and liquidity.⁴

⁴ See, respectively, SR letter 09-4; SR letter 06-17, “Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL);” and SR letter 10-6, “Interagency Policy Statement on Funding and Liquidity Risk Management.”

Contacts

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Deputy Director

Cross references:

- SR letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management"
- SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies"
- SR letter 06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)"
- SR letter 84-16, "Farm and Agricultural-Related Loans"
- Federal Reserve *Commercial Bank Examination Manual*, section 2140, "Agricultural Loans"

⁵ See <http://www.federalreserve.gov/feedback.cfm>.