July 31, 2018

Presidents and Chief Executive Officers of Tenth District State Member Banks with a Significant Exposure to Agricultural Credit Risk

Subject: Results of the 2018 Tenth District State Member Bank Agricultural Survey

The Federal Reserve Bank of Kansas City (Reserve Bank) recently conducted a survey of 46 Tenth District State Member Banks (the banks) with significant exposure to agricultural (ag) credit risk to better understand regional market and banking conditions[1]. The results of the 2018 survey revealed the banks' liquidity risk is increasing and overall credit risk has stabilized at an elevated level.

Aggregate liquidity risk has increased for the surveyed banks primarily due to recent loan growth which has caused these banks to maintain smaller cushions of liquid assets and increased reliance on noncore funding sources. Year-over-year, the banks' median liquid asset-to-total asset ratio declined from 12.7 percent to 10.5 percent, and one-third of the deposit growth was attributed to an increase in brokered deposits. Moreover, the increasing trend in liquidity risk is reflected in the aggregate loan-to-deposit ratio increasing to 87 percent, up from 84 percent from the prior survey, with several banks now reporting loan-to-deposit ratios over 100 percent.

As outlined in Supervision and Regulation (SR) Letter 10-06[2], "*Interagency Policy Statement on Funding and Liquidity Risk Management,"* a critical component of an institution's ability to effectively respond to potential liquidity stress is the ready availability of a cushion of highly liquid assets without legal, regulatory, or operational constraints. In other words, liquid assets should be unencumbered and have the ability to be sold or pledged to obtain funds quickly in a range of stress scenarios. The size of the cushion of liquid assets should be supported by estimates of liquidity needs performed under the institution's own adverse scenario analysis and be aligned with the board of directors' (board) risk tolerance. The quality of unencumbered liquid assets is also important to ensure accessibility during the time of most need.

In general, ag borrower financial stress is driving elevated loan demand and a slight increase in nonperforming ag loans. Since the prior survey, the banks' aggregate loan volume increased 5.4 percent with a 5.2 percent increase in Tier 1 capital. Ag loans comprised over half of total loan growth, and loans secured by farmland made up two-thirds of ag loan growth with farm production loans making up the other third. In aggregate, the banks reported a moderate yet elevated ratio of adversely classified assets to Tier 1 capital plus the Allowance for Loan and Lease Losses (ALLL) of 20 percent compared to 19 percent in last year's survey. Adversely classified carryover debt levels remained stable from last year's survey levels, representing a manageable 2.5 percent of Tier 1 capital plus the ALLL. The banks also reported generally positive performance among local "main street" businesses that are not directly dependent on ag production. In addition, the 2018 survey results indicate more frequent use of government loan guaranty programs with highly leveraged borrowers to help mitigate the banks' overall heightened credit risk profile.

The banks' ALLL levels did not materially change from prior years' surveys as the median ALLL to total loans ratio represented 1.40 percent compared to 1.42 percent at year-end 2016. The banks made adjustments to ALLL factors in prior years due to the gradual financial stresses in the regional ag markets that began several

[1] *For purpose of this survey, an ag bank is defined as any commercial bank with combined agricultural production loans and loans secured by farmland equal to or exceeding 25 percent of total loans and ag concentrations exceeding 250 percent of total risk-based capital.*

[2] *https://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm*

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years ago. Low provision expenses coupled with modest loan growth helped boost the banks' earnings performance, with the banks' earnings performance comparable to 2016 as the median 2017 Sub-S adjusted return on average assets stayed near 0.90 percent.

Overall, responses to the 2018 survey noted that bank management teams remain cognizant of the heightened credit risks related to low commodity prices, trade/tariff policy uncertainty and weather conditions. More specifically, bankers continue to focus on staying in close contact with ag borrowers to monitor operating costs, family living expenses, and marketing plans, etc., to ensure the farm operator has the financial strength and strategies in place to manage through the current market challenges and volatility. It is worth noting bank management's identification of a troubled borrower does not prohibit the bank from working with the borrower, and bank management is encouraged to continue making prudent loans to creditworthy farm operators despite the potential for more severe financial stresses.

The 2018 survey also revealed the majority of the banks reported more instances of formalized policies and monitoring procedures that specifically address carryover debt, and only a few of the banks still lacked policy guidance and formal monitoring processes to identify, track and report carryover debt to the board. As outlined in SR Letter 11-14[3], "*Supervisory Expectations for Risk Management of Agricultural Credit Risk,*" a bank should have appropriate policies and controls to monitor and segregate agricultural carryover debt. When carryover debt arises, the bank should confirm and understand the fundamental causes of carryover debt (e.g., weaknesses in a borrower's financial condition or operations or a poor marketing plan), so that an informed decision can be made on whether the debt restructuring and risk rating is appropriate. The restructured debt should generally be on a term basis and require clearly identified collateral, an amortization period that aligns with the life of the related collateral, and payment amounts based on realistic expectations. Overall, the Reserve Bank has a long standing expectation that banks maintain risk-management programs and sound lending standards throughout credit cycles. Risk management practices should provide for early detection, intervention, and adjustments when credit and liquidity risk are rising.

We express our sincere appreciation for taking time to respond to the 2018 annual survey. Your valuable perspectives and insights contribute to a shared understanding of our regional market conditions and community banking conditions. If we can be of any assistance to you in the future, please contact your local Reserve Bank Central Point of Contact.

Sincerely,

James H. Hunter
Vice President

cc: Tenth District State Bank Commissioners

[3] *https://www.federalreserve.gov/supervisionreg/srletters/sr1114.htm*