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RISK MANAGEMENT SUPERVISORY EXPECTATIONS FOR AGRICULTURAL CREDIT RISK

NOVEMBER 2012

Background

Global demand for agricultural commodities continues to intensify, giving rise to improved profits and increased investment and production of various agricultural commodities. Supply and demand pressures have had a significant effect on the volatility of agricultural commodity prices, farmland values, and farm production costs, increasing the risk to agricultural lenders. In response to these developments, on October 26, 2011, the Federal Reserve Board issued supervisory policy letter SR 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk," (SR 11-14) to serve as a reminder of the key risk factors associated with agricultural lending and to highlight supervisory expectations with respect to risk management practices.[1] The guidance outlined in the policy letter applies to all banking organizations, including community banks with significant exposure to agriculture-related credit risk.

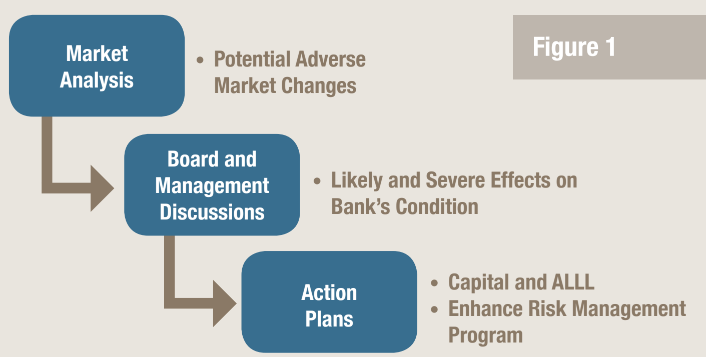
Supervisory Expectations for Board and Management Oversight

A bank's board of directors and senior management are responsible for establishing the overall tolerance for risk and for ensuring that the bank maintains an appropriate risk management program. In the context of agricultural risk, a key element of board and senior management oversight is developing an understanding of how current and potential changes in market conditions will impact the bank's risk profile. Furthermore, the board and management should identify contingency adjustments that could be made so that the bank can withstand periods of adverse market conditions.

For most community banks with significant agricultural exposures, board and management oversight can be accomplished through a periodic review and discussion of market conditions,[2] potential adverse outcomes, and how changes could affect the bank's financial condition. These discussions may lead to appropriate adjustments to the bank's risk management framework, the adequacy of capital, and the allowance for loan and lease losses (ALLL). When the board engages in such a discussion, a summary of the discussion and rationale for any decisions should be noted in the board minutes. In situations where the board and management determine that potential increased risk warrants adjustment to the bank's agricultural risk management, the minutes should include a description of planned adjustments.

For example, Bank A has a significant concentration of dairy producer loans. If market outlook reports for the dairy industry suggest that rising feed and other production costs will place pressure on operating margins and that milk prices are expected to decline, dairy producers' profits would be expected to fall during the coming year. In this situation, examiners would expect to see that board and management discussions note the concentration and percentage of dairy-related borrowers in Bank A's lending portfolio that have marginal debt service coverage capacity. The board and management may determine that adjustments should be made to the bank's risk management practices related to these loans to minimize potential losses. These adjustments may include, for example, requiring additional collateral and/or increasing monitoring of potential problem borrowers. The board and management may also decide to assess the impact of potential losses on capital and include this information in environmental factors as part of the ALLL methodology (ASC Topic 450). Figure 1 illustrates this process.

Figure 1



FedLinks is intended to highlight the purpose of supervisory policy and guidance for community banking organizations. FedLinks does not replace, modify, or establish new supervisory policy or guidance.

1 The supervisory expectations outlined in the SR letter are based on existing guidance covered in section 2140 of the Federal Reserve's *Commercial Bank Examination Manual*.
2 Information on market conditions can be obtained in a variety of ways. Examples of resources are listed below under *Federal Reserve Bank (FRB) Agricultural Credit Surveys*.

Supervisory Expectations for Credit Risk Management Program

Policy letter SR 11-14 highlights minimum supervisory expectations for a banking organization's agriculture-related risk management program. Although not all-encompassing, Federal Reserve examination staff considers the following bank actions to be indicative of a sound risk management program.

- Developing well-written credit policies that delineate the bank's overall lending philosophy and guidelines. At least annually, or when significant changes occur, the board should review and enhance the bank's policies.
- Documenting how board-approved policies will be clearly understood and implemented throughout each level of the organization.
- Addressing who has the lending authority by lender or board committee to ensure compliance with the bank's internal guidelines and procedures.
- Creating strong credit memos that formally address a borrower's creditworthiness using financial analysis of a borrower's cash flow and debt service coverage, cash flow projections, sensitivity analysis, and reliable collateral evaluations. In addition, providing details regarding the loan structure, compliance with bank underwriting standards, and controls used to monitor and segregate the use of carryover debt.
- Creating a standard checklist to help ensure that all applicable documents are obtained when a loan is made, including current financial statements, livestock and crop production records, tax returns, UCC-1 filings, collateral inspections, and evidence of insurance. Because of the large volume of required documents, many of which need to be updated at least annually, it is imperative that a bank is committed to a sound loan documentation program that establishes responsibility for obtaining documents, monitoring compliance, and providing follow-up to help ensure that all required documents are obtained in a timely manner.
- Implementing management information systems that produce accurate and timely reports to the board. Effective board reporting should provide meaningful stratifications of the bank's agricultural portfolio in order to better identify potential risk exposures (for example, large borrowing relationships, repayment source as a percent of total capital, and primary industry exposures such as wheat farming, row crop production, cow/calf operation or feed lot production).
- Ensuring accurate credit risk ratings through internal or external independent loan reviews.
- Incorporating market issues in capital planning and the ALLL methodology for environmental factors (ASC Topic 450).

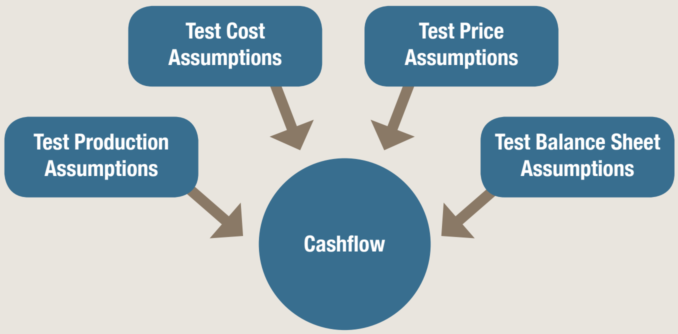
Strong and well-disciplined credit risk management programs have historically proven effective through even the most severe agricultural market downturns.

Assessing a Borrower's Creditworthiness and Cash Flow Projections

Assessing borrower creditworthiness, particularly for large, complex, or marginal debt-service-capacity borrowers, requires a thorough analysis of projected income and expenses, working capital adequacy, capital expense analysis, reliability of off-farm income sources, and cash flow adequacy. Borrower projections should be analyzed and compared to actual results from prior years and available area market data to assess their reliability and feasibility.

Borrower projections should also be analyzed to determine ability to generate sufficient cash flow to service obligations, and cover working capital needs. This analysis should include some demonstration or discussion of the borrower's ability to manage through adverse conditions. In assessing the ability of cash flow to withstand adversity, the bank should conduct a sensitivity analysis to identify any potential concerns about repayment ability. Key elements of this analysis include reviewing the reasonableness of projections for production capacity, production costs, and commodity prices. These projections should be stressed to assess relative flexibility to manage through adverse conditions. Scenarios should consider the borrower's personal risk management strategy, especially types and uses of crop insurance. Planned capital expenditures and any significant projected changes to the borrower's balance sheet also should be evaluated for reasonableness. Figure 2 illustrates some elements of a sensitivity analysis, but is not all-inclusive.

Figure 2



Consistency is a key component in developing an effective sensitivity analysis process; any analysis is only as strong as the quality of the information available. A consistent approach is recommended, although in some isolated cases the bank may need to tailor or modify its analysis to account for a borrower's specific condition or circumstance, such as enterprise, size, costs, values, structure, business cycle, etc. Banks that use a consistent, balanced approach to credit analysis can employ both quantitative information and personal judgment in the evaluation of agricultural credit.

Underwriting Standards

Agriculture is by nature a cyclical industry. Therefore, it is important that banks perform periodic reviews of credit policies and procedures to ensure that they remain appropriate for current trends in the industry. This process becomes increasingly important during periods where market conditions are expected to have a profound impact, either favorable or unfavorable, on a customer's condition.

Expectations for growth, increased competition, or changes in local, regional, or national economic conditions may also warrant modifications to underwriting standards. Moreover, examiners expect the management team to formally approve and note adjustments to the bank's loan covenants such as standard minimum debt-service-coverage ratios and maximum loan-to-value ratios in board meeting minutes. Overall, the bank should underwrite loans based on a comprehensive assessment of the borrower's financial condition and overall creditworthiness, with cash flow serving as the primary source of repayment. Collateral position should not be the primary justification for providing financing to individual agriculture-related credits.

Loan Structure

One of the major causes of problem loans relates to the bank's inability to properly structure an agricultural credit. At a minimum, examiners expect banks to appropriately align type and terms with the loan purpose and likely repayment sources and, when appropriate, develop loan covenants such as maximum debt-to-asset ratios, collateral inspections, and capital expenditures to protect the bank's interests. Any additional loan support such as guarantees and crop insurance requirements should be well documented. The consequences of failure to perform as agreed should be clearly documented before any funds are advanced.

Credit Administration and Carryover Debt

SR 11-14 also highlights the importance of monitoring and segregating carryover debt. Carryover debt normally results from the borrower's inability to generate sufficient cash flow to repay production loans from the current operating cycle. Since the purpose of carrying over debt is to improve cash flow to ultimately retire that debt, credit memos will need to clarify the reasons for this strategy, the viability of the borrower's operation, and whether a debt restructuring aligns with the bank's internal policy guidelines. Examiners expect banks to identify a borrower's carryover debt and stale portions of revolving lines of credit and determine if the borrower has sufficient equity and cash flow to repay the debt if restructured. The continued use of carryover debt or non-revolving lines would generally reflect a well-defined credit weakness and expose the bank to potential losses.

Collateral Management

The bank's collateral position is the safety net if repayment from cash flow fails and asset liquidation becomes the only repayment option. Examiners expect management to maintain reliable collateral evaluations and reasonable collateral margins, along with a well-documented process that requires periodic monitoring of pledged collateral ensuring the bank's lien perfection has been accomplished. The frequency of collateral inspections should align with the bank's loan policy, the degree of risk related to the agricultural sector, and the type of collateral pledged.

Supervisory Guidance

Policy letter SR 11-14 provides examination and supervisory expectations for banks with significant agriculture-related risk exposure and may be accessed on the Federal Reserve Board's public website, and in section 2140 ("Agricultural Loans") of the Federal Reserve's *Commercial Bank Examination Manual.* Additionally, in response to recent severe drought conditions across much of the Midwest and southern portions of the US, the Federal Reserve Board along with other members of the Federal Financial Institutions Examination Council (FFIEC) issued supervisory policy letter SR 12-13, "FFIEC Statement on the Impact of Drought Conditions on Financial Institutions," on October 19, 2012, to encourage bankers to work with their customers and borrowers affected by these drought conditions.

Conclusion

Volatility in agricultural markets reinforces the importance of sound risk management practices and capital planning at banking organizations with exposure to agriculture-related risks. Sound risk management practices, as outlined in the supervisory guidance listed above, should be broadly applicable irrespective of agricultural market conditions. Ultimately, it is sound risk management practices that will best position a bank to withstand a downturn in agricultural sectors.

Federal Reserve Bank (FRB) Agricultural Credit Surveys

Information about agricultural market conditions can be accessed from a variety of sources. Several Reserve Banks conduct quarterly surveys of agriculture credit conditions and farmland value changes. Additionally, the United States Department of Agriculture (USDA) provides a wide range of reports and data on market conditions, as do several universities. These information sources can be used to supplement local and regional markets information. Below are descriptions and links to several Reserve Bank reports that are accessible to the public. These links are intended to serve as a starting point and are not required to be used, nor are they the only market information that should be utilized.

- *FRB Chicago AgLetter* is a quarterly publication that summarizes survey data for agricultural land values and credit conditions in the Chicago district: Agricultural Survey
- *FRB Dallas Agricultural Survey* reports on agricultural credit conditions and farmland values for the Dallas district: Agricultural Survey
- *FRB Kansas City Agricultural Credit Conditions* reports on agricultural credit conditions and farmland values for the Kansas City district: Agricultural Survey
- *FRB Minneapolis Agricultural Credit Conditions Survey* reports on agricultural credit conditions and farmland values for the Minneapolis district: Agricultural Survey
- *FRB Richmond Survey of Agricultural Credit Conditions* reports on agricultural credit conditions and farmland values for the Richmond district: Agricultural Survey
- *FRB St. Louis Agriculture Finance Monitor* reports on agricultural credit conditions for the St. Louis district: Agricultural Survey