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AGRICULTURAL CREDIT RISK MANAGEMENT

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Background

Agriculture is a capital intensive and potentially volatile industry; commodity prices, farmland values, and production costs are all highly sensitive and susceptible to market swings that can negatively impact risk exposure, particularly at banks with large concentrations of agricultural lending. In acknowledgment of these conditions, the Federal Reserve Board issued Supervision and Regulation Letter (SR) 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk," which emphasizes key risk factors associated with agricultural lending and highlights supervisory expectations for banking organizations' risk management practices.[1,2] The expectations outlined in the policy letter apply to all banking organizations, but most specifically to community banks with significant exposure to agriculture-related credit risk.

Supervisory Expectations for Board and Management Oversight

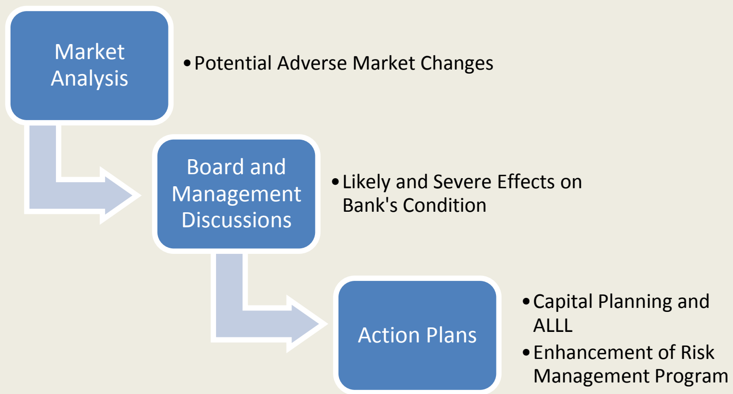
The Federal Reserve Board recently issued SR Letter 16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion," that outlines core risk categories and risk management principles that are pertinent to agricultural credit risk. Supervisory expectations for the roles and responsibilities of a bank's board of directors and senior management include establishing the overall tolerance for risk and ensuring maintenance of an appropriate risk management program. A key element of sound oversight is developing an understanding of market conditions and how potential changes may affect a bank's financial condition and risk profile.[3] For most community banks with significant agricultural exposure, this understanding can be achieved with regular review and discussion of local and global market conditions, assessment of potential outcomes based on current market conditions and trends, and consideration as to how potential outcomes may positively or negatively impact the bank's financial condition and risk profile. These discussions should prompt a review of a bank's risk management framework, including the adequacy of capital and the allowance for loan and lease losses (ALLL). Additionally, the board and management should identify contingency strategies that will position the bank to withstand periods of adverse market conditions. A summary of the analysis, discussion, and rationale for decisions should be noted in the board minutes. Figure 1 illustrates this process.

1 Supervisory expectations include thorough assessment of borrower creditworthiness and cash flow, effective underwriting standards, appropriate credit administration and controls, proper loan structure, and reliable collateral evaluations and reasonable collateral margins.

2 The supervisory expectations outlined in SR Letter 11-14 are based on existing guidance covered in section 2140 of the Federal Reserve's *Commercial Bank Examination Manual*.

3 Information on market conditions can be obtained in a variety of ways, including the agricultural surveys listed on page 4.

Figure 1



Supervisory Expectations for Agricultural Credit Risk Management Program

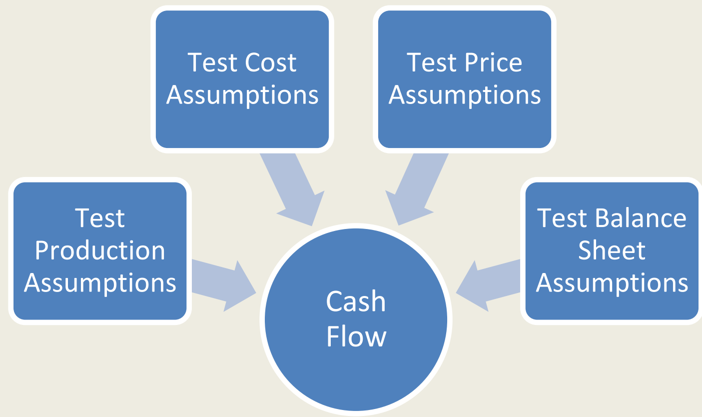
Strong, well-disciplined credit risk management programs have historically proven effective even through the most severe agricultural market downturns. SR Letter 11-14 highlights minimum supervisory expectations for a bank's agriculture-related risk management program. Expectations for risk management programs are dependent on a bank's size, complexity, and risk characteristics. Sound risk management practices should be emphasized at all times rather than only during a prolonged market downturn. For example, credit memos should include an assessment of a borrower's creditworthiness using analyses of cash flow, debt service coverage, cash flow projections, sensitivity analysis results, and collateral evaluations when farm income levels are at all-time highs as well as when market outlooks appear negative. Almost by definition, agricultural banks lack diversification in their loan portfolios; however, a sound agricultural credit risk management program can help mitigate concentration risk. The board should ensure that management and staff have the knowledge and experience to identify, measure, monitor, and control the bank's unique agricultural risks. Effective credit concentration management information system reporting can help provide meaningful stratifications of a bank's agricultural portfolio, as a percent of total capital, in order to identify potential risk exposures. For example, potential portfolio segmentation would include more granularity than just broader Call Report categories such as primary industry/commodity (for example, wheat farming, row crop production, cow/calf operation, feed lot production, and large borrowing relationships).

Assessing a Borrower's Creditworthiness and Cash Flow Projections

A borrower's operating and financial projections should be analyzed to evaluate whether the cash flow will be sufficient to service obligations and cover working capital needs even during periods of adverse conditions. For this reason, a sensitivity analysis is a useful tool for analyzing a borrower's financial condition. Adverse scenario analysis should consider the borrower's personal risk management strategy, including types and uses of crop insurance and appropriate hedging strategies. Planned capital expenditures and any significant projected changes to the borrower's balance sheet should be evaluated for reasonableness and factored into forward-looking analysis. Figure 2, while not all-inclusive, illustrates basic elements of cash flow sensitivity analysis.

Consistency is essential in developing an effective sensitivity analysis process. Analysis and results will only be as strong as the quality of information available. The methodology and assumptions applied during sensitivity analysis should be well documented in lending procedures. Banks that use a consistent, balanced approach to credit analysis can more effectively employ both quantitative information and personal judgment in the evaluation of agricultural credit. Examiners will continue to evaluate the reasonableness of the cash flow projections for production capacity, production costs, and commodity prices.

Figure 2



Underwriting Standards

Agriculture is inherently a cyclical industry. Therefore, it is important that banks perform periodic reviews of credit policies and procedures to ensure they remain appropriate. Expectations for loan portfolio growth, increased competition, elevated levels of loan portfolio concentration, or changes in local, regional, or national economic conditions may warrant modifications to underwriting standards. Changes to underwriting standards should be formally approved and noted in board minutes. Ultimately, bank management should underwrite loans based on a comprehensive assessment of a borrower's overall financial condition and creditworthiness in light of environmental factors. Cash flow should serve as the primary source of repayment. Collateral position should not be the primary justification for providing financing to individual agriculture-related credits.

Loan Structure

Improperly structured agricultural credit relationships can lead to future problems in loan performance and repayment. At a minimum, credit terms should align with a loan's purpose and timing of primary source(s) of repayment. Loan covenants should be used when necessary to enhance a bank's ability to monitor and control the advancement of funds. Additional support or credit enhancements such as guarantees or crop insurance should be well documented in a bank's lending policies and borrower loan files.

Carryover Debt

By its nature, carryover debt generally suggests a well-defined credit weakness. However, it is important to note that it does not prohibit a banker from working with a borrower. Carryover debt typically results from a borrower's inability to generate sufficient cash flow to repay production loans from the current operating cycle. Examiners will not automatically classify carryover debt and, instead, will carefully examine all relevant data to ensure an accurate risk rating. Besides assessing individual borrowing relationships with carryover debt, examiners' focus will be on an agricultural bank's processes for monitoring and segregating carryover debt. Lending policy guidance should be formalized and clearly outline a bank's approach to identifying and treating carryover debt. Furthermore, carryover debt should be appropriately secured and amortized over a reasonable term that is consistent with a borrower's repayment capacity and collateral pledged. A practice proven effective is for a bank to segregate operating notes by crop year and not comingle operating proceeds between the different growing seasons. If loan proceeds are comingled for more than one crop year, a bank should be able to document operating proceeds for each year to support management's risk ratings and repayment analysis. When collateral does not cover carryover debt and repayment capacity is not evidenced, bank management should classify the carryover balance and determine whether a loss rating is appropriate.

Collateral Management

Collateral is a secondary source of repayment, a safety net if the primary source of repayment, most typically cash flow from operations, fails and asset liquidation becomes the only repayment option. Therefore, examiners will evaluate a bank's collateral procedures and practices. The self-liquidating benefits associated with, for example, production and feeder loans are lost if a bank does not monitor and exercise sufficient control over the disposition of the proceeds for the sale of these commodities. In agricultural lending, collateral control is mainly accomplished by periodic onsite inspections and verifications of the security pledged, and by implementing and enforcing procedures that require a customer to apply sales proceeds to the associated debt before releasing those proceeds for other purposes. In some cases, annual collateral inspections may be sufficient, while in other cases, much more frequent collateral inspection may be necessary to ensure the bank's ongoing control of collateral. A bank's board-approved policies and procedures should clearly outline the board's expectations for the frequency of collateral inspections and valuations and be commensurate with the risk of the collateral and the overall degree of risk within the individual borrowing relationship.

Capital Planning

From a supervisory perspective, risk is the potential that events, expected or unexpected, will have an adverse effect on a bank's capital. Agricultural-related borrowers are definitely vulnerable to a number of external risks, including volatility in commodity prices, farmland values, production costs, and weather conditions. This underscores the importance of considering industry credit concentrations in the formulation of capital plans. It is critical for agricultural bankers to remember that market conditions are often volatile and a prolonged adverse agricultural market can increase borrowers' problems and impair a borrower's collateral values, negatively affecting a bank's ability to withstand a sustained market downturn. As a result, the board of directors should ensure that its capital planning practices are sufficiently robust to withstand potential future market and economic distress. This will likely include the identification of potential risk exposure (for instance, concentration risk) as well as metric-based triggers that cause management to initiate contingency plans to reduce exposure and/or augment capital.

Supervisory Guidance

Examination and supervisory expectations for banks with significant agriculture-related risk exposure are outlined in SR Letter 11-14 and may be accessed through the Federal Reserve Board's website. Additional guidance can be found in section 2140 ("Agricultural Loans") of the Federal Reserve's *Commercial Bank Examination Manual*.

Conclusion

The potential for volatility in agricultural markets reinforces the importance of sound risk management practices and capital planning at banking organizations with significant exposure to agriculture-related risks at all times and not just when market outlooks are negative. Sound risk management practices, as outlined in supervisory guidance, are broadly applicable regardless of agricultural market conditions. Ultimately, sound risk management practices will position a bank to navigate a downturn in local, regional, and global agricultural sectors.

Resources

Information about agricultural market conditions can be obtained from a variety of sources. Several Reserve Banks conduct quarterly surveys of agriculture credit conditions and farmland values. Additionally, the United States Department of Agriculture provides a wide range of reports and data on market conditions, as do several universities. Below are descriptions and links to Federal Reserve Bank (FRB) reports that are accessible to the public. These links are intended to serve as a starting point; their use is not required nor is it the expectation that they be the only market information considered.

- **FRB of Chicago *AgLetter*,** available at www.chicagofed.org/publications/agletter/index, is a quarterly publication that summarizes survey data for agricultural land values and credit conditions in the Chicago District.
- **FRB of Dallas *Agricultural Survey*,** available at www.dallasfed.org/research/agsurvey/index.cfm, reports on agricultural credit conditions and farmland values for the Dallas District.
- **FRB of Kansas City *Survey of Agricultural Credit Conditions*,** available at www.kansascityfed.org/research/indicatorsdata/agcreditsurvey, reports on agricultural credit conditions and farmland values for the Kansas City District.
- **FRB of Minneapolis *Agricultural Credit Conditions Survey*,** available at www.minneapolisfed.org/publications/agricultural-credit-conditions-survey, reports on agricultural credit conditions and farmland values for the Minneapolis District.
- **FRB of St. Louis *Agriculture Finance Monitor*,** available at www.research.stlouisfed.org/publications/regional/ag-finance/, reports on agricultural credit conditions for the St. Louis District.

Supervisory guidance related to agricultural credit risk is available in the SR letters listed below.

- SR Letter 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk," available at www.federalreserve.gov/bankinforeg/srletters/sr1114.pdf.
- SR Letter 16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion," available at www.federalreserve.gov/bankinforeg/srletters/sr1611.pdf.
- Section 2140, *Commercial Bank Examination Manual*, available at www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf.

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