PRUDENT MANAGEMENT OF AGRICULTURAL LENDING DURING ECONOMIC_CYCLES

I. BACKGROUND

The Federal Deposit Insurance Corporation (FDIC) has issued an advisory reminding financial institutions engaged in agricultural lending to maintain sound underwriting standards, strong credit administration practices, effective risk management strategies, and appropriate allowances for losses and capital levels through the credit cycle. When agricultural borrowers experience financial difficulties, the FDIC encourages financial institutions to work constructively with borrowers to strengthen the credit and mitigate loss.

II. 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. The Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines), promulgated pursuant to Section 39 of the Federal Deposit Insurance Act, indicate that all insured institutions should have, among other things, a system of effective internal controls, appropriate loan documentation practices, prudent underwriting practices, and a system of ongoing credit and asset quality reviews.

Risk analysis that centers on a borrower’s cash flow and repayment capacity and that does not overly rely on collateral values is crucial. For most agricultural loans, primary repayment sources include cash flows from anticipated crop production and livestock operations. Therefore, assessment of the timing and level of projected cash flows over a reasonable period, and ensuring that cash flows match the purpose and terms of a loan, are keys to effective credit analysis. 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 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. A borrower’s management abilities and experience are also part of the equation.

In addition to primary cash flow analysis, consideration of secondary repayment sources and collateral support levels is important. For example, a borrower’s informed use of crop insurance and appropriate hedging products can reduce risks to the farming operation and the lending institution. Properly administered credit enhancements, such as government guarantees, can also reduce credit loss exposures.
Managing risk over the life of a loan includes: carefully documenting all lien perfections and other loan instruments; closely overseeing sale proceeds; conducting timely, independent collateral inspections; and developing a process for monitoring collateral values. A continuous credit grading program can help management identify credit risk early and take preemptive steps to prevent further deterioration. Assigning initial credit grades, ensuring timely grade changes, and assessing the adequacy of the Allowance for Loan and Lease Losses in light of grade changes are vital.

Concentrations of credit to individual borrowers or segments of the agricultural industry warrant careful identification and management. Effectively managing credit concentrations and complying with statutory lending limits does not entail automatically refusing credit to sound borrowers because of their particular business segment or geographic location. Instead, the creditworthiness of individual borrowers, an institution’s risk appetite and tolerance, and the adequacy of risk management practices remain critical loan decision factors. Agricultural lending policies that detail the board’s risk tolerances and include appropriate procedures for identifying, monitoring, and controlling concentrations are practices crucial to effective lending.

Lastly and importantly, ensuring that the lending function is properly staffed with well-trained individuals to perform the risk management practices listed above can help limit deterioration in credit quality, even in a challenging underwriting and collection environment.

III. DEVELOPING APPROPRIATE WORKOUT STRATEGIES FOR AGRICULTURAL CREDITS

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 financial institution.

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.

IV. CAPITAL

The Guidelines set the standards used by the FDIC to identify and address problems at FDIC-supervised financial institutions before capital becomes impaired. Management’s careful and proactive consideration of capital levels through cycles, and having and following a plan to monitor and augment capital as needed, can allow the institution to better weather periods in which adverse financial results are experienced.

The foregoing Compliance Update is for informational purposes only and does not constitute legal advice. As a reminder, the NBA general counsel is the attorney for the Nebraska Bankers Association, not its member banks. The general counsel is available to assist members with finding resources to help answer their questions. However, for specific legal advice about specific situations, members must consult and retain their own attorney.