Prudent Management of Agricultural Credit through Farming and Economic Cycles

The U.S. agricultural industry has generally benefited from almost a decade of solid farm production and strong demand. According to the U.S. Department of Agriculture, six of the past eight years rank among the top ten income-producing years (inflation adjusted) since 1980. In addition, livestock commodities have improved during the past year, and the cattle and the hog sectors expect continued modest improvement for 2011. However, the dairy sector continues to struggle from the price shocks of 2008 and 2009.

The generally strong financial performance of the agricultural sector also is reflected in the agricultural credit quality reported by the nation's farm banks. The sector appears poised to remain on a path of prosperity at least over the near term and possibly longer. Crop prices remain high, the 2010 production of wheat, corn, and soybeans is projected to be strong, and livestock prices also are trending up. Median agricultural loan delinquencies and charge-offs remain near the lowest levels since the early 1970s. The positive performance in the industry has improved cash receipts and allowed farmers to make additional investments in farmland and equipment. These factors contribute to the perception that the current state of the agricultural sector is the best it has been in many years.

Despite the good financial news related to agriculture, the sector remains susceptible to shocks from a variety of sources, including weather-related or other environmental shocks, market volatility, rising interest rates, geopolitical risks, and the potential for a decline in commodity prices or farmland values. Because the worldwide agricultural sector is primarily commodity driven, agricultural prices can be dramatically influenced by external shocks and supply and demand changes. External shocks affecting one area of the United States, a particular part of the world, or specific commodities may significantly affect other commodities or producers in other locations. Price uncertainty due to market fluctuations is particularly severe in export markets. Even during this period of strong financial performance in the agricultural sector, banks must remain diligent in developing and enforcing sound underwriting principles and establishing effective risk management and control procedures. Because agriculture is vulnerable to sharp shifts in commodity prices and operating costs, this level of volatility warrants implementation of strong risk-mitigation strategies.

Prudent Credit Risk Management for Agricultural Lending

Financial institutions engaging in agricultural lending should implement a prudent credit risk management process that places a strong emphasis on borrower cash flow and repayment capacity, and does not place undue reliance on collateral. Many successful agricultural lenders have developed a strong knowledge of the farm sector and a deep understanding of individual borrowers and their businesses. This helps lenders establish appropriate loan structures and repayment plans based on the local agricultural base and customer credit needs.

For most agricultural loans, the primary source of repayment is often the cash flow derived from crop production or livestock operations, which are subject to the vagaries of the agricultural markets. Accordingly, farm credit analytics should be thorough and include projected cash flows over a reasonable range of future conditions that may affect commodity and farm land prices. In many cases, smaller farms rely on their principals' personal wealth and resources to support ongoing operations; therefore, a borrower's credit history and financial strength are critically important components of assessing their willingness and ability to repay, and should be considered in conjunction with other subjective factors, such as the borrower's management capabilities and experience. In addition, the structure and terms of agricultural loans should be appropriate for the borrower's funding needs given the timing of cash flows from farm operations.

Institutions also should analyze secondary sources of repayment and the strength of collateral support. Lenders should not rely solely on agricultural real estate collateral, but rather should focus on each borrower's cash flow position. Institutions should be sensitive to evidence of speculation in agricultural land prices or commodities that are influencing the market, and remain focused on repayment ability and borrower underwriting. In addition, the FDIC recognizes that other secondary sources of repayment and risk mitigation may be particularly useful in managing loan risks. For example, a borrower's informed use of crop insurance and true hedging activities can serve to lessen risk for the farming operation and lending institution.

Concentrations of credit to individual borrowers or segments of the agricultural industry also should be closely monitored and managed. Although the FDIC expects institutions to effectively manage credit concentrations, lenders should not automatically refuse credit to sound borrowers because of their particular business segment or geographic location. Instead, loan decisions should be based on the creditworthiness of the individual borrower, consistent with prudent management of credit concentrations.

Developing Appropriate Workout Strategies for Agricultural Credits

The FDIC recognizes that some agricultural sectors, including dairy farming operations, have not experienced favorable business conditions and are constrained by diminished cash flows and reduced collateral values. During the agricultural crisis of the 1980s, agricultural borrowers experienced short-term deterioration in their financial condition because of commodity price volatility, depreciating land values, and rising input prices. Nonetheless, many of those farms continued to be profitable, creditworthy bank customers that demonstrated a willingness and capacity to repay debts over time. In cases where farming operations are struggling to make payments, financial institutions and borrowers often find it mutually beneficial to work constructively to restructure agricultural credit facilities.

The guidelines and principles presented in the October 30, 2009, *Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts* (CRE Loan Workouts Guidance) can and should be readily adapted to lending relationships in the agricultural sector. The FDIC has found that prudent commercial loan workouts are often in the best interest of the financial institution and borrower, and workouts can take many forms including a renewal or extension of loan terms, the extension of additional credit, or a restructuring with or without concessions. Such a restructuring may improve a lender's prospects for principal and interest repayment and remain consistent with sound banking, supervisory, and accounting practices. At the same time, loan restructures can help farmers negotiate adverse business conditions or volatility in commodity or land prices. Allowing additional time can help farms stabilize operations and mitigate bankers' risk of loss.

Institutions should consider loan workouts after analyzing a farming operation and repayment capacity. Agricultural loan workouts should ensure the institution maximizes its recovery potential. From a supervisory perspective, restructured loans to farming operations with the ability to repay debts under reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount less than the loan balance. 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 provided management has adopted the principles of the CRE Loan Workouts Guidance.

Given the potential challenges facing the agricultural sector and the existing problems confronting the dairy sector, the continued availability of credit will be vital to the success of our nation's farming operations. As stated in previous supervisory guidance, including the February 2010 *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* and the November 2008 *Interagency Statement on Meeting the Needs of Creditworthy Borrowers,* the FDIC encourages financial institutions to prudently make loans to creditworthy farms in their local markets.

Agricultural operations are a critical component of our economy as farms need access to credit for working capital and long-term financing needs. Community banks, in particular, have demonstrated a strong commitment to agricultural financing, and the FDIC expects farmers' legitimate credit needs will continue to be met.