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Subject: Guidance for Evaluating the Safety and Soundness of FCS Real Estate Lending (focusing on land in transition)

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PURPOSE

Farm Credit System (FCS or System) institutions have a fundamental responsibility to ensure any proposed financing of agricultural land in transition is both 1) safe and sound and 2) permissible. This Examination Bulletin provides safety and soundness guidance to Farm Credit Administration (FCA) examiners for evaluating FCS real estate lending, with a focus on "land in transition." In so doing, it provides further guidance on FCA's regulatory requirements for lending policies and underwriting standards found in FCA Regulation 614.4150. This Examination Bulletin is designed to complement FCA Bookletter No. 58 "Financing Agricultural Land in Transition (in the Path of Development) -- Eligibility and Scope of Financing Considerations," which provided related eligibility and scope of financing criteria. Both of these documents need to be referenced for their respective purposes.

BACKGROUND

As defined in Bookletter No. 58, "land in transition" is agricultural land that lies in the path of development. It is land that is at some stage in the process of transitioning from a primarily agricultural (including timber) use to some form of residential or commercial use. The per acre land value is typically higher than traditional agricultural land, with the valuation generally driven by the land's future development value or other factors that are not tied to the historic or projected cash flow from the real estate's agricultural production. An appraisal is likely to indicate that the highest and best use of the real estate is other than agricultural.

Lending on land in transition can pose unique and higher risks than traditional agricultural loans due to various factors, including those related to the nature of the collateral, the type and nature of the customer, and the lender's underwriting experience. These risks are further accentuated during adverse economic times. While financing land in transition may occur, the FCA has consistently directed that FCS institutions may not provide development financing that converts agricultural land to non-agricultural uses, except in very rare instances.

While FCS institutions have latitude to engage in appropriate lending activities to meet eligible bona fide farmers' credit needs, it is not the intent of FCA to encourage land-in-transition lending through the issuance of this document. **Any System institution that engages in this type of lending must do so in a safe and sound manner.**

CONSISTENCY WITH INTERAGENCY GUIDELINES

FCA considered many sources as it developed the safety and soundness expectations in this Examination Bulletin. In addition to the best practices observed in some FCS institutions, the

Agency considered the standards established by the other Federal financial regulators. These regulators have issued “Interagency Guidelines for Real Estate Lending Policies” (Interagency Guidelines). These Interagency Guidelines provide consistent regulatory criteria for real estate lending. The Interagency Guidelines are provided in Attachment I. Examiners should consider the additional direction provided in the Interagency Guidelines, particularly for those institutions with lending activities involving land in transition. It is noteworthy that the expectations in this Examination Bulletin are consistent with the expectations applied by other Federal regulators.

SAFETY AND SOUNDNESS GUIDANCE

As noted above, **any System institution that engages in land-in-transition financing must do so in a safe and sound manner.** Appropriate oversight of this lending activity would include develop-ment of sufficient board policy guidance, supporting procedures, and corresponding control processes (including adequate monitoring and reporting), consistent with the requirements of FCA Regulation 614.4150. The depth of this lending guidance and supporting processes should be commensurate with the level of actual and/or planned lending activity in this area.

Financing land in transition poses higher and unique risks that FCS institutions must specifically address in their underwriting and risk management practices. Of particular concern are risks related to collateral, repayment capacity, and borrower character. When evaluating land-in-transition lending activities, examiners should consider whether the FCS institution has adequately addressed and controlled these risks as discussed in the following sections.

Loan-to-Value Limits

FCS institutions must establish appropriate loan-to-value (LTV) limits through board-approved underwriting standards. LTV limits are one of the key controls an institution board must establish for real estate lending. The Interagency Guidelines contain a table that provides the maximum real estate LTV limits established by other Federal banking regulators (see Attachment I). FCA examiners should carefully evaluate FCS board-approved underwriting standards considering the limits used by other Federal banking regulators. Any FCS LTV standards for land in transition that are less restrictive than the corresponding 65 percent regulatory maximum applicable to other commercial lenders should be carefully scrutinized.

An institution’s policy direction on LTV limits should reflect a direct and critically-important correlation between the strength of the cash flow that underlies the real estate and the corresponding maximum LTV limit. For example, most land in transition has limited cash flow relative to its market value. In contrast, most farmland that is being actively used for agricultural production has substantial cash flow relative to its market value. Since the cash flow on land in transition is typically low relative to its appraised value, the LTV limit should be correspondingly lower.

For the reasons mentioned above as well as the inherent risk associated with lending on land in transition, FCA examiners should expect to see significant LTV restraint by FCS institutions and failure to do so could be considered unsafe and unsound. Conservatism in this area is particularly important as land-in-transition financing involves high-risk characteristics as discussed in this Examination Bulletin (including typically limited cash flow relative to market value) and requires specialized lending experience to properly control and manage the risk in this market segment. Recent history has shown that loans on land in transition have a high loss given default, which also supports the need for a lower LTV limit to control collateral risk.

A maximum advance rate per acre can be an effective additional method of controlling collateral risk. Many institutions effectively use dollar-per-acre advance limits on various types of real estate, particularly when the property's cash flow is low relative to market value. Maximum advance per acre limits are frequently used in combination with LTV limits, with the lower limit applied for underwriting purposes.

Valuation of Real Estate Collateral

Under FCA Regulations, the valuation of collateral requires consideration of the income capitalization approach either through the formal appraisal or through the underwriting process. A discussion of the income-generating ability of the real estate frequently serves to help identify the property as land in transition. While an appraiser may determine the income capitalization approach is not applicable for valuation purposes, the agricultural income-generating capability, or lack thereof, should be clearly identified, carefully considered in the lending decision, and fully addressed in the underwriting process.

The following are other key collateral and appraisal-related factors:

- The appraisal should always identify the highest and best use of the property. If the highest and best use is other than agricultural production, this should be clearly identified and addressed in the loan underwriting analysis.

- If the appraised value is based upon future subdivision and resale of property, utmost caution should be used. Moreover, that valuation should be supported by a sufficient analysis of related costs, projected sales prices, and the anticipated timing and duration of sales. Use of valuations that are dependent on future zoning changes is not appropriate.

- The property's sales history, including past ownership and sale prices, should be addressed in the appraisal or within the loan underwriting analysis. Sales between any related buyers and sellers must be carefully scrutinized and only relied on if independent arms-length pricing can be confirmed.

- Appraised values that are higher than the current purchase price require extreme scrutiny and explanation. Moreover, an appropriate LTV advance rate should be established and applied against the lower of the purchase price or the appraised value.

Agricultural Production and Debt Service Coverage

Agricultural land should generally sustain production activities that generate sufficient income to support reasonable debt service coverage. Land values that cannot be supported by income generated by the production activities on that land are subject to increased volatility and risk, requiring further support from the borrower's other available and sustainable income sources. System institutions' real estate lending policies, procedures, and lending practices should reflect a direct correlation between the property's cash flow available for debt service and approved LTV levels, as discussed above. Furthermore, FCA Regulation 614.4150(g)(1) requires that institutions have loan underwriting standards in place that determine whether an applicant has the operational, financial, and management resources necessary to repay the debt from cash flow.

In addition to the subject property's cash flow, the borrower's overall repayment capacity can be supported based on the borrower's other available and sustainable sources of debt repayment. Appropriately structured and properly underwritten loans can be further supported by cash flow from other income sources such as co-borrowers or guarantors. In all cases, however, examiners should ensure that System institutions fully evaluate the quality and stability of the repayment sources and establish lending controls to ensure that sufficient supplemental cash flow will be available and sustainable to repay the loan.

While stable, recurring cash flow from these supplemental sources can reduce repayment risk and strengthen the overall credit, substantial caution must be taken to avoid reliance on any nonrecurring income sources. **In evaluating cash flow available for debt service, capital gains and other nonrecurring income should be scrutinized carefully, appropriately discounted from the analysis, and not relied upon for required debt service coverage.** Furthermore, the stability/reliability of the recurring income sources should be addressed in the loan underwriting process, with correspondingly less weight given to income sources that the lender has minimal ability to secure or control.

Repayment Through Sale of Collateral

Repayment of FCS real estate loans should not be dependent on the sale of the underlying collateral. Real estate loans where repayment is dependent on the liquidation of collateral (or other real estate) are much more uncertain and volatile in nature and are generally not consistent with sound lending practices for an FCS institution. Such loans require significantly increased levels of lending expertise, policy guidance, procedures, underwriting, controls, and monitoring.

If an FCS institution has a sound basis for making a rare exception and approves a real estate loan where the primary source of repayment is expected to come from the sale of the collateral (or other real estate) over time, a principal pay down schedule should be included in the approval process and become an integral and controlling part of the loan agreement. The pay down schedule should reflect the lender's analysis of the applicable marketplace's absorption rate and the resulting timeframe for the sale of individual parcels until the loan balance is fully repaid. It should also include minimum partial release prices for real estate collateral. The release prices should be in excess of the pro rata loan amount and ensure that the lender will be repaid in full prior to the release of all collateral and prior to the borrower being allowed to withdraw profits or equity investment. A marketing plan and independent feasibility study should also be required to support this type of loan.

If the FCS lender envisions occasional partial release of collateral, applicable loan conditions or covenants should be established and enforced to ensure sufficient loan pay down and appropriate ongoing control, monitoring, and valuation of the remaining collateral.

Loan Structure and Terms

The loan structure and terms should match the customer's agricultural needs, the intended loan purpose, and the expected source of repayment. Loans should be structured with regularly-scheduled principal and interest installments based on an appropriate amortization schedule and considering the borrower's income stream. Short-term real estate loans or balloon maturities should be tied to a specific strategy to mitigate risk or meet the specific appropriate needs of a customer. Applicant loan requests that include minimal down-payment or amortization requirements, interest only payments, and/or short-term balloon payments may suggest that the applicant's financing needs are not agricultural and may result in excessive risk to the lender. Such loans require careful scrutiny and a more thorough underwriting process to explain and justify the related circumstances.

If a System institution is financing an applicant who is less than a full-time farmer and whose agricultural real estate being financed has a high probability of being developed, the loan should be structured in a manner that provides for the institution to exit the relationship before any development occurs.

Customer Risk

Customer risk to FCS institutions can materially increase when applicants are realtors, developers, attorneys, or others with minimal ties to agriculture, limited farming activities, or significant land-in-transition activities. These types of borrowers are frequently more motivated to set up single-purpose limited liability entities in an effort to limit their personal liability exposure. They may also strongly desire limited personal guarantees and decline to offer spousal signatures or guarantees.

An accurate financial position of this type of "professional" customer can be much more difficult to determine due to interests in multiple legal entities and projects, many of which may be minority interests that are typically difficult to verify and accurately value. In general, these types of minority interests also have limited accessibility and value in a loan workout or collection scenario.

Collectively, these customer factors require a substantially higher level of lender experience, expertise, and analysis to adequately identify and understand the full comprehensive financial position and performance of the customer and all of the related risks. FCS institutions should only finance customers and credits that they are fully equipped to successfully analyze, underwrite, structure, service, and collect (whether as an originator or a participant).

Stress Testing

Recent adverse and unstable economic and market conditions have reinforced the need for proactive stress testing of loans and portfolios. The credit analysis of larger and more complex loans should routinely include stress testing of key variables, e.g., interest rates, income, expenses, land values, etc. Similarly, FCS institutions should routinely stress test various portfolio segments to proactively evaluate concentration risks and the vulnerability of their portfolio segments to various potential adversities.

Risk Management

FCS institutions that engage in lending on land in transition should have particularly strong loan portfolio management processes in place to proactively identify, manage, and mitigate the elevated risks associated with this type of financing. The depth and sophistication of land-in-transition-related lending policy guidance and supporting processes should be commensurate with the level of existing and/or planned lending activity in this area. Attachment II outlines specific examination guidance for evaluating portfolio risk management, loan underwriting, and loan servicing practices applicable to land-in-transition financing.

December 10, 2009 | Thomas G. McKenzie
Date | Thomas G. McKenzie
 | Chief Examiner

Attachment I

Interagency Guidelines

The Interagency Guidelines for Real Estate Lending Policies (Interagency Guidelines) provided in the embedded files below represent the longstanding, industry-wide regulatory safety and soundness guidance for real estate lending by U.S. commercial lenders, including any land-in-transition financing. The concepts and direction contained in these Interagency Guidelines represent sound banking practices in the financial services industry. The Interagency Guidelines are broad and cover a wide range of real estate lending activities, not all of which are applicable to FCS institutions. Nevertheless, System institutions engaging in land-in-transition lending (or other applicable real estate lending) should do so under board policy direction which fully considers the standards and criteria set forth in the Interagency Guidelines.

The following table from the Interagency Guidelines, with parenthetical additions to correlate with FCS lending activities, has particular relevance for institutions when establishing underwriting standards and appropriate board policies. Examiners should consider these maximum LTV limits and other relevant guidance found in the Interagency Guidelines as they conclude on the safety and soundness of FCS institution lending practices.

Interagency Guidelines -- Supervisory Loan-to-Value Limits	
Real Estate Loan Category	**Loan-to-Value Limit**
Raw land *(including typical land in transition)*	65%
Land development *(acquisition plus development costs)*	75%
Construction:	
Commercial, multifamily, and other nonresidential	80%
1- to 4-family residential	85%
Improved property *(including traditional income-producing agricultural real estate)*	85%

- FDIC regulations containing the Interagency Guidelines:

  FDIC REG 365-Real Estate Lending Std.pdf

- OCC Handbook section containing the Interagency Guidelines:

  Commercial Real Estate and Construction Lending.pdf

Attachment II

Examination Considerations for Evaluating Land-in-Transition Financing

This attachment supplements the more general guidance provided in the body of this Examination Bulletin by providing more specific examination considerations for evaluating FCS land-in-transition lending activity (or other similar FCS real estate lending). These considerations are categorized into three areas – portfolio management, loan underwriting, and loan servicing.

Portfolio Management Considerations

FCS institutions engaging in land-in-transition lending should have correspondingly strong portfolio management processes in place to proactively identify, manage, and mitigate the unique and increased risks associated with this lending activity. Factors to evaluate include:

- Are related policy guidance, procedures, and internal controls of sufficient specificity, quality, and depth? Related considerations include:
    - Are these items developed commensurate with the level of existing and planned lending activity in this area?
    - Is the institution's lending guidance consistent with the guidance provided in this Examination Bulletin?
    - Does this lending guidance appropriately address and conform to the regulatory guidance provided in FCA's May 28, 2009 Bookletter No. 58 entitled "Financing Agricultural Land in Transition (in the Path of Development) – Eligibility and Scope of Financing Considerations"?
    - Is the policy direction established by the board of directors consistent with supporting management procedures and internal controls?

- Does the institution have adequate underwriting direction in place for this portfolio segment? Related considerations include:
    - Are the underwriting standards/criteria approved by the board of directors?
    - Does the risk appetite in this area fit the institution's risk-bearing ability?
    - Are the applicable underwriting standards/criteria clear and measurable?
    - Are cash flow and repayment capacity sufficiently emphasized?
    - Has the board established appropriate LTV limits (e.g., <=65%)? Were maximum advance rate per acre limits adopted (or considered) as a supplemental underwriting control? Were all relevant risk factors considered in determining these limits?

- Do institution management and staff have sufficient lending expertise to appropriately support their lending activity in this area?

- Has the institution considered and established appropriate portfolio concentrations limits for this type of lending?

- Are related loan underwriting exceptions actively tracked, analyzed, and reported to senior management and the board?

- Is a loan coding/identification process in place that facilitates accurate identification and reporting of the volume of land-in-transition loans?

- Does management conduct appropriate stress testing of this portfolio segment?
- Does management actively monitor applicable real estate market conditions and trends, including market supply and demand factors? Are applicable real estate valuation trends actively tracked and considered?
- Does the internal credit review function timely and sufficiently evaluate this portfolio segment?
- Are sufficient monitoring and reporting processes in place to actively oversee and report on the nature, volume, quality, and performance of this portfolio segment?

Loan Underwriting Considerations

FCS underwriting of land-in-transition (or other similar FCS real estate) loans should address all typical credit factors and issues applicable to traditional FCS real estate lending. The following items, however, warrant particular attention:

- Is the purpose of the loan clearly and accurately captured in the underwriting analysis? Does the institution properly recognize the account as a land-in-transition loan?
- Does the underwriting analysis adequately emphasize the importance of sufficient recurring and sustainable cash flow and repayment capacity? Considerations include:
    - Does the analysis discuss the agricultural income-generating capacity of the collateral?
    - How significant is the land's agricultural net production income relative to the corresponding debt service requirements when amortized over a reasonable time period?
    - Is there a secondary source of repayment? Is it a recurring and stable income source?
    - Have capital gains, or any other nonrecurring income, been appropriately discounted in the analysis and thus not relied upon for meeting debt service requirements?
    - Has the institution ensured that loan repayment is not dependent on the sale of the underlying collateral or of other real estate? If the institution has a loan granted (on a rare exception basis) where loan repayment is materially dependent on the sale of the collateral or other real estate, has this loan been properly supported by an appropriate principal pay down schedule, marketing plan, and independent feasibility study?
- Is the LTV level appropriate for the unique risk factors of this credit (including sufficiently below the institution's policy standard when appropriate)? If the appraised value exceeded the current purchase price of the collateral, was the LTV advance rate applied to the lower of the purchased price or appraised value?
- Is there documented support for the level of the borrower's hard equity investment (i.e., cash or other tangible collateral)? Does this hard equity investment represent <u>at least</u> 35 percent of the lesser of the purchase price or appraised value?
- Has customer risk been adequately evaluated and addressed? Considerations include:
    - Does the underwriting analysis address all relevant customer risk factors?
    - If the borrowing entity is structured as a legal entity, have the principals cosigned or guaranteed the loan? If guarantees are used, what is the quality of these

guarantees (e.g., guarantee performance throughout the life of the loan or only actionable after liquidation of collateral, unlimited or limited in dollar amount, full guarantees or limited to pro rata interests or other criteria, etc.)?

- ➢ Are spouses included as cosigners or guarantors (or not at all)?
- ➢ Are the financial statements of sufficient quality given the size and complexity of the account and borrower?
- ➢ Are applicable financial statements properly consolidated and analyzed?
- ➢ Have assets, liabilities, and income been adequately verified? How stable are the asset values and income sources and levels?
- ➢ If applicable, has the generally limited practical value of minority interests in multiple legal entities been acknowledged/addressed?

- Does the appraisal provide adequate and appropriate support for the loan?

Considerations include:

- ➢ Does the appraisal include an income capitalization approach to valuation?
- ➢ Does the appraisal identify the highest and best use of the property?
- ➢ Does the appraised value anticipate subdivision, change in use, and/or resale of the property? If so, is it supported by sufficient related analysis? Is the appraised value consistent with current zoning, or is it dependent upon an assumed or projected change in zoning?
- ➢ Has the property been recently sold or subdivided? Did the price or appraised value increase significantly? Were the buyer and seller related in any way (including any common shareholders/members)?
- ➢ Are the comparable sales relied on also land-in-transition properties with high valuations?
- ➢ Are a few buyers controlling or impacting sales prices and values in the area or is the market widely diversified?

- Has sufficient research (via the Internet or otherwise) been completed to ensure the institution has an accurate and complete understanding of the borrower's plans for the property, including any potential development plans?

- Does the underwriting analysis include stress testing of various key variables, e.g., interest rates, income, expenses, land values, etc.?

- Does the underwriting analysis evaluate and address applicable real estate market risks relevant to the subject property?

- If this is a purchased loan interest, did the institution complete its own independent and thorough analysis of the credit?

- Are overall loan terms and conditions appropriate? Considerations include:
  - ➢ Is the term of the loan appropriate for the underlying collateral? Does it match an agricultural purpose?
  - ➢ Are there regularly-scheduled principal and interest payments based on an appropriate amortization schedule?
  - ➢ If a short-term or balloon structure is used, is it tied to a specific strategy to mitigate risk or meet an appropriate need of the customer? If booked as a Title I loan, is the loan term at least 5 years in length (as required by law and regulations)?
  - ➢ Are financial loan covenants in place (e.g., minimum net worth level or equity percentage, minimal debt service coverage, etc.)? Is a maximum LTV level established?

- Is loan pricing appropriate based on market conditions and the loan's risk factors?
- If occasional partial releases of collateral are anticipated, are appropriate corresponding loan conditions or covenants established?

Loan Servicing Considerations

Land-in-transition (or other similar FCS real estate) loans generally entail increased ongoing risks and can have various loan servicing issues. Loan servicing actions may indicate changes in the risk and should be carefully evaluated accordingly. While typical loan servicing expectations apply, the following considerations warrant particular attention:

- Is the borrower experiencing financial stress due to adverse economic conditions or other factors? Has the borrower requested any form of forbearance (payment deferral, extension, reamortization, interest only payments, etc.)?
- Have any administrative servicing actions caused the loan to remain current when it otherwise would have become past due? Related considerations:
    - Were any such actions fully supported and appropriate to address only temporary cash flow issues?
    - Were updated financial statements obtained and thoroughly analyzed?
    - Is the borrower current on non-FCS debts, real estate taxes, accounts payables, etc.?
    - Is the borrower clearly viable?
    - Did the lender receive appropriate borrower considerations in return (e.g., additional collateral, capital injection, additional or strengthened covenants, fees, interest rate adjustments, etc.)?
    - Was the servicing action for appropriate loan servicing and risk mitigation reasons (and not to defer or potentially mask emerging loan performance problems)?
    - If the loan remains "in substance past due" with material weaknesses, has it been appropriately considered for nonaccrual status?
- Have any other loan terms or conditions been modified resulting in the loan being in compliance when there otherwise would have been a technical default? Was this servicing action fully supported and appropriate?
- Has the loan been increased or modified in any way that notably increases the dependence on the real estate collateral (including any direct or indirect advances, separate notes, etc.)? If so, was the action supported by a current appraisal (generally less than 12 months old or more current if warranted by market conditions)?
    - If additional loan advances were granted, were the proceeds used to meet FCS debt service requirements or was the borrower allowed to reduce his/her equity in the real estate collateral?
- If partial releases of collateral are allowed for in the loan documents or have otherwise been permitted:
    - Are minimum release prices set by formula and determined so as to require accelerated pay down of the loan or do they permit the borrower to remove capital gains/profits and/or otherwise reduce borrower equity in the property?
    - Is the value of the remaining collateral supported by sufficient updated/current appraisals?
- Are current financial statements periodically obtained and analyzed as necessary to monitor and manage the risk in the account (customer risk, financial trends, cash flow sufficiency, etc.)?

- Are the loan’s assigned risk rating, loss given default, performance status, and potential specific allowance needs periodically reviewed and updated as necessary to reflect current conditions and risks?
- If the loan declines to a criticized credit classification or worse, is an applicable loan service plan developed to proactively address and mitigate loan weaknesses?

Note: The issues and considerations addressed above are not intended to be all inclusive. Rather, this document combined with the Interagency Guidelines (included in Attachment I) and other forms of FCA guidance are collectively intended to provide applicable guidance on this topic.