Farm Credit Administration

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INFORMATIONAL MEMORANDUM

January 29, 2015

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit System Institutions

From: Samuel R. Coleman, Director and Chief Examiner Samuel R. Coleman
Office of Examination

Subject: Portfolio Management in Volatile Times

The Farm Credit System (FCS or System) remains fundamentally safe and sound overall, but due to continuing volatility in agriculture, many segments are experiencing significant challenges. For example, the dramatic declines in grain prices, as well as ongoing drought in major agricultural regions of the country, increases the likelihood of significant portfolio challenges for many FCS institutions during the next several years. We previously communicated this concern, and our resulting emphasis on portfolio management in our September 9, 2014 Informational Memorandum discussing the Office of Examination's 2015 National Oversight Plan. This Informational Memorandum expands on that communication and discusses emerging risks and areas we will be examining to determine how FCS institutions are responding to the volatile environment.

Agriculture has experienced a period of record profitability, but economic conditions are changing. Prices for grain, particularly corn and soybeans, have dropped sharply and are expected to remain lower for the next several years. While this has strengthened margins for livestock producers, grain producers are facing more difficult conditions. Operating expenses and input costs, including rental rates for land, are not expected to adjust as quickly, resulting in significant decreases in margins, and possibly losses for many grain producers. These conditions would affect borrower repayment capacity and liquidity, and very possibly solvency and collateral values. This environment could be particularly challenging for borrowers that recently acquired higher-priced real estate (owned or leased) or made significant capital expenditures on equipment or facilities. Either may have been done at the expense of building adequate working capital while operating conditions were favorable. Similarly, drought conditions in California and the southern plains pose a significant threat to the profitability of agricultural operations in those regions. A recent economic analysis of the 2014 drought in California estimated that the direct costs to agriculture in that state alone could total $1.5 billion.

Given these and other conditions that increase volatility in agriculture, proactive and diligent portfolio management is critical to ensure a System institution operates in a safe and sound manner. Proactively managing the portfolio involves early detection of potential risks through ongoing monitoring of industry and weather conditions, portfolio analysis, and timely and accurate risk identification, along with sound loan underwriting. Once potential risks are identified, they can be managed through disciplined underwriting of new business, adjustments to concentration limits, effective loan servicing, and other portfolio management strategies and processes. As such, our examinations will continue to focus on an institution's processes or efforts to:

- Identify and increase monitoring of borrowers that are most vulnerable to lower commodity prices, drought conditions, or any other emerging risks and identify opportunities for proactive servicing.
- Ensure repayment capacity projections are realistic, recognizing the profitability of the past five years may not be an accurate reflection of the next several years.
- Understand and emphasize borrower risk management practices (e.g., marketing plans and insurance coverage) in evaluating projections, establishing loan conditions, and making credit decisions.
- Adjust loan terms, pricing, and covenants (such as limits on capital expenditures and use of funds) to mitigate increasing credit risk.
- Adjust repayment capacity and liquidity standards to reflect the higher level of volatility being experienced.
- Identify and analyze exceptions to underwriting standards, including monitoring changes to exception levels.
- Identify and report increased credit risk in a timely and accurate manner through the Uniform Classification System, risk ratings, and the allowance for loan loss process.
- Ensure adequate resources and expertise to meet increased loan servicing demands if portfolio deterioration is expected.
- Stress test portfolios under a variety of scenarios, including a "severe yet plausible" scenario, to assess the potential impact of changing conditions on borrowers, collateral values, asset quality, and the institution's financial condition and performance.
- Integrate stress testing results and other portfolio or industry analyses into portfolio planning processes and develop appropriate strategies to address emerging or expected risk. Potential strategies include adjusting underwriting standards or hold limits, limiting underwriting exceptions, and maintaining or improving the institution's risk-bearing capacity.

We understand the FCS's challenges in working with creditworthy borrowers through periods of adversity that are inherent in agricultural lending, while at the same time ensuring full compliance with FCA borrower rights regulations. Since additional borrowers may become distressed due to the conditions discussed above, we will give additional attention to compliance with these regulations. We will also evaluate whether institutions are fully analyzing the borrower's financial condition and performance and determining the borrower's ability to repay under reasonable terms before renewing and restructuring loans.

Finally, we realize the increased volatility in agriculture may present opportunities for institutions to increase market share as commercial banks pull back from this segment of the market. While such opportunities can be pursued in a safe and sound manner, FCA will look for evidence that new lending activity does not weaken the overall quality of the loan portfolio or make it more susceptible to deterioration. We would be particularly concerned about increased financing to new borrowers that have not maintained adequate liquidity or repayment capacity during favorable, and in some instances, record periods of profitability. As such, FCA examiners will closely evaluate the underwriting and quality of new business in the current environment.

Please direct questions about this Informational Memorandum to your Examiner-In-Charge or Doug Alford, Credit Specialist Program Manager, at (720) 213-0961 or email alfordd@fca.gov. Additional information on FCA's expectations and related examination guidance addressing loan portfolio management can be found on FCA's website at http://www.fca.gov/info/portfoliomanagement.html.