Farm Credit Administration

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INFORMATIONAL MEMORANDUM

January 21, 2016

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

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

Subject: Servicing Loans to Borrowers in Distressed Industries

This memorandum is a follow-up to the Farm Credit Administration's January 2015 communication entitled "Portfolio Management in Volatile Times." In that communication, we discussed important portfolio management topics in light of threats present in agriculture, such as declining commodity prices and worsening drought conditions. This memorandum expands on the loan servicing component of portfolio management when industries are under widespread stress.

As you know, economic conditions in agriculture have become more challenging since early 2015. Grain prices, especially for corn and soybeans, remain low compared to the past several years. Production costs, however, have not declined as significantly. As a result, even some of the most efficient cash grain operations are experiencing losses. Declining margins are now evident in most livestock segments as well, which is a notable contrast to early 2015 when nearly all livestock operations were generating profits. Also, drought conditions in California remain, and states in the Southeast have seen significant crop losses due to significant flooding in some areas.

Fortunately, most Farm Credit System (System) institutions have the financial capacity and risk-bearing ability to work with borrowers experiencing stress. We expect System institutions will use this capacity to work with borrowers as they navigate through a potentially stressful period. To do so, System institutions will need to intensify loan servicing efforts as borrowers begin encountering increased stress. Loan servicing is always important, but it becomes critically important when a large number of borrowers are potentially threatened by weak industry conditions.

During periods of industry stress, servicing actions to address credit weaknesses typically increase. Examples of these actions could include new term loans to fund operating losses, rebalance debt, or provide working capital; covenant waivers or adjustments; principal

deferments; term debt reamortizations; and operating loan extensions. Regardless of the servicing action taken, institutions should generally first complete a comprehensive evaluation of the borrower's financial condition and performance, operations (e.g., cost structure, diversification, performance versus peers and industry averages, etc.), managerial abilities, collateral, and prospects for repayment using realistic projections. Current, accurate, and complete information on the borrower's financial condition and performance and collateral is essential for completing such an evaluation. This information is needed to accurately and realistically identify credit risk, which is a prerequisite for determining the appropriate servicing action and identifying borrowers that warrant continued financing despite current losses. Credit decisions made without this analysis increase institution risk and can result in untimely and inaccurate risk identification and inappropriate servicing actions. Loans with credit administration weaknesses that materially increase risk or otherwise hinder timely and accurate risk identification may contribute to assigning a criticized classification.

The following are key factors System institutions should consider when servicing loans to borrowers in distressed industries:

- Are borrower weaknesses and resulting risk exposures recognized accurately, and proactively addressed?

- Is current financial information obtained and appropriately analyzed?

    - Is financial information of sufficient quality to make sound and constructive loan decisions?
    - Has financial information been adequately verified and adjusted in light of falling machinery values, softening land prices, and lower inventory values?
    - Are credit bureau reports and lien searches completed to identify if debt from input suppliers or other sources is rising?
    - Do financial statements include sufficient information to determine historic and projected net income, cash flow, and capital debt repayment capacity?
    - Are cash basis income statements reconciled to changes in earned net worth and analyzed to determine profitability on an accrual basis?
    - Are financial projections realistic in light of current cash prices, historic yields, futures market prices, and guaranteed revenues provided by crop insurance coverage?
    - If expected long-term prices are used to show the borrower warrants continued financing, does supporting analysis show the borrower has the financial strength (i.e., owner equity and working capital) to fund losses, maintain an adequate collateral position, and service debt until long-term prices return?
    - Are reasonable asset values used when rebalancing or restructuring debt against longer term assets (especially for real estate that experienced

rapid value increases during the past several years or for machinery, which recently had notable price declines)?

- After actions to rebalance, restructure, and provide new debt, can the borrower service the resulting debt through operating cash flow at current prices? If not, has sufficient analysis been completed to show the borrower has adequate working capital to fund losses and service debt until profitability is expected to be restored?
- Has monitoring of borrower condition and performance increased?

- Is collateral analysis based on current, reliable, independent appraisals or collateral valuations and are collateral analysis efforts supported by onsite, physical inspections?

- Are customer contacts, onsite inspections, and updated collateral evaluations performed with greater frequency and completed in a timely manner?

- Are forbearance, restructuring, and other servicing actions (e.g., covenant waivers or adjustments) documented and supported?

  - Does the borrower's cost of operations support long-term viability?
  - Is management able and willing to make necessary changes?
  - Is the balance sheet strong enough to support debt restructuring?
  - Are adequate controls in place to manage the increased risk exposure (e.g., borrowing base, controls over disbursements, loan covenants, limitations on capital spending, sufficient quality and frequency of financial reporting, and collateral inspections)?
  - Did the borrower make meaningful concessions (e.g., additional collateral, additional reporting, capital injections, or higher quality financial statements)?

- Were guarantees, cosigners, capital injections, or other credit enhancements pursued?

- Are written loan servicing plans in place that address the basis of criticism, planned servicing actions and dates for completion, target date of upgrade or payoff, and individuals responsible for servicing actions?

When servicing actions involve a loan that meets the regulatory definition of *distressed*, institutions must ensure compliance with all applicable borrower rights provisions. We expect institutions will work with borrowers consistent with the System's mission to furnish sound, adequate, and constructive credit. In this regard, we encourage institutions to review FCA's borrower rights regulations (12 CFR Part 617) and policies and procedures especially in the areas of Distressed Loan Restructuring, Right of First Refusal, and Credit Review Committees. Institutions should also increase related training as needed and ensure internal audit programs provide appropriate coverage of these areas. Institutions should refer to guidance provided on distressed loans in the FAQs About Borrower Rights on FCA's web site.

Please direct questions about this Informational Memorandum to your Examiner-In-Charge or Doug Alford, Credit Specialist Program Manager, Office of Examination, at (720) 213-0961 or alfordd@fca.gov.