Farm Credit Administration

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INFORMATIONAL MEMORANDUM

March 29, 2011

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

Chief Executive Officer
All Farm Credit System Institutions

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

Samuel R. Coleman

Subject: Loan Underwriting Standards – Borrower Financial Information

The purpose of this informational memorandum is to convey the Farm Credit Administration's (FCA) expectations regarding the collection of borrower financial information and the impact of this information on loan underwriting standards. FCA Regulation 614.4150(a) requires, in part, that Farm Credit System (FCS) institution boards and management adopt written policies and procedures prescribing standards for collecting and verifying borrower financial information. Increased volatility in the agricultural sector and the complexity of the financial structure of many farm operations increase the importance of obtaining financial statements regularly as a sound business practice and as a critical tool to enable institutions to properly measure and manage risks. Current borrower financial information will also ensure underlying data used to conduct stress testing and to determine the allowance for loan losses are adequate. For these reasons and to ensure guidelines are consistent with the institution's lending environment, the board and management should review policies and procedures that control collecting and verifying borrower financial information.

Policy Direction

Bookletter BL-037 "Lending Policies and Loan Underwriting Standards Regulations," which FCA issued on October 28, 1997 (BL-037), continues to offer relevant guidance to FCS institutions' boards. The bookletter emphasizes the need for boards to establish policies for obtaining current and reliable borrower financial information. By regulation, these policies must identify

- the frequency for requiring financial information;
- verification expectations of financial information; and
- minimum financial information required taking into account the loan size, complexity, and risk exposure of the credit relationship.

The board should ensure that the institution's audit and review program evaluates compliance with the board's policy regarding borrower financial information.

Frequency of Collection

Policies and procedures should address when current financial information is required. Although FCA removed the regulation requiring FCS institutions to obtain annual financial statements from most borrowers, FCA generally considers financial information to be current if it is no more than twelve months old. The extent of the financial information collected after loan origination should consider factors such as the nature of the operation, the type of loan actions, loan size, credit risk, repayment terms, and loan program. For example, the risks inherent in a small to moderate sized seasoned mortgage loan may warrant periodically obtaining borrower credit bureau information and performing lien searches to properly monitor credit risk. On the other hand, the risks inherent in a commercial operation frequently warrant complete borrower financial statements on a more regular basis. Additionally, a pool of credit scored transactions could warrant a soft credit inquiry[1] as part of an institution's regular loan portfolio monitoring efforts. Obtaining, verifying, and analyzing financial information periodically will allow an institution to remain apprised of a borrower's operating performance throughout the life of the loan and enable the institution to make proactive risk identification, lending, and servicing decisions.

Reliability of Financial Information

Policies and procedures should also address the board's and management's expectations regarding the quality of borrower financial information. Historically, the extent and quality of financial information available on agricultural operations has varied significantly. In general, small loans to noncomplex farm operations may rely on borrower-prepared cash-basis financial information, while large commercial operations should provide compiled, reviewed, or audited accrual financial statements. Complex operations, such as vertically integrated, specialized, or large commercial operations with interrelated businesses, should provide consolidated audited financial statements. While the need for audited financial statements will vary by the risks inherent in a specific credit relationship, FCA expects institutions to obtain audited statements for loans presenting a material exposure to an institution's risk-bearing capacity or earnings performance.

Impact on Loan Underwriting Standards

Credit files should document a thorough analysis of compliance with loan underwriting standards using current and reliable financial information. FCA encourages the board and management to ensure loan underwriting standards place emphasis on borrower liquidity, cash flow, and repayment capacity to ensure safe and sound lending. This is especially important in an environment of volatile land and commodity prices. When making credit decisions, institutions should be sensitive to evidence of increased, and possibly unsustainable, agricultural land or commodity prices that could inflate financial statements.

Please provide copies and discuss the contents of this memorandum with your board, pertinent board committees, senior management team, and other appropriate staff involved in credit risk management or review. FCA examiners will review board policies and procedures to determine that such standards are established and implemented for all lending programs. If you have any questions about this memorandum, please contact either your designated examiner-in-charge or Lynn Major for the Office of Examination at majors@fca.gov or (877) 322-6253 extension 4285.

Copy to: Farm Credit Council
Farm Credit Services

[1] A "soft credit inquiry" refers to a credit report check that does not affect the borrower's credit score; it is also known as a "soft pull."