Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

INFORMATIONAL MEMORANDUM

June 17, 2010

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

Chief Executive Officer
All Farm Credit System Institutions

From: Thomas G. McKenzie, Director and Chief Examiner
Office of Examination

Thomas G. McKenzie

Subject: Collateral Risk Management in Farm Credit System Institutions

The volatility and substantial declines in certain real estate markets are a growing concern. Most notably, during the past 24 months, pressure on the protein sector (specifically livestock and dairy facilities), housing and land-in-transition properties has led to significant loan losses and highlights the need for strong collateral risk management as part of ongoing loan portfolio management (LPM) practices. The challenges experienced during this period should have motivated all Farm Credit System (FCS or System) institutions to reassess the adequacy of their LPM practices, including the management of collateral risk.

This Informational Memorandum (IM) is provided to encourage boards and senior management to improve collateral risk management practices in System real estate lending activities. Accurate identification, systematic measurement, routine reporting, and effective controls are important for managing collateral risk and minimizing loss exposure from real estate lending. Sound collateral risk management is also a key factor in determining the institution's allowance for loan loss and capital needs, as well as providing a foundation for stress analyses and contingency planning.

The Farm Credit Administration (FCA or Agency) previously issued an IM on collateral risk (Capitalizing Collateral Risk) in March 2005 emphasizing the impact of collateral risk on System portfolios. We defined real estate collateral risk as the portion of real estate value that is not supported by the net income derived from the real estate's normal production of and prices for agricultural products (including net rental income that can be realized from the property and its facilities). We believe income producing capacity is a fundamental aspect of any collateral risk identification and measurement process. In the March 2005 FCA IM, we outlined five collateral risk issues that impact real estate portfolios. Four of the five issues are particularly relevant today, and are already affecting real estate collateral values within FCS portfolios:

1. Declines in disposable incomes or changes in economic factors or investment strategies for investors in agricultural real estate (especially land-in-transition properties);

2. Industry or sector stress (such as dairy, swine, biofuels, non-farm employment, etc);
3. Changes affecting the profitability of specific commodities, such as exports or changes in government support programs; and,
4. Trends of local and national economies.

The fifth factor identified in our 2005 memorandum, “significant increases in real estate mortgage interest rates,” has not yet occurred, but given present historically low levels, most economists expect rates to rise. Prudent LPM practices, including a sound stress testing process, should include an evaluation of the effects that a material increase in interest rates might have on collateral values and other credit risk factors that ultimately impact the overall portfolio condition and performance. How much collateral and credit risk would result in your portfolio if interest rates increased 200 basis points? 400 basis points?

FCA issued an IM on December 16, 2009, entitled National Oversight Plan for Fiscal Year 2010. This communication highlighted the identification and management of collateral risk in System institution portfolios as one of our key examination priorities in the coming months. The need for institutions to understand and manage the level of collateral risk embedded in their respective portfolios has grown in importance given the volatility in commodity and input prices and the current economic conditions, which continue to pressure real estate values. It is especially important to develop servicing plans for loans that have excessive collateral risks.

Institutions can anticipate expanded examiner analysis of LPM practices, including the review of collateral risk exposure. The board and management of each institution should ensure that the identification, measurement, reporting and controls over collateral risk are sufficient to ensure that an overall sound LPM system is in place. The attachment to this memorandum outlines our expectations for identifying, reporting, and managing collateral risk. In the attachment we also have included some reminders of FCA requirements and our expectations for the appraisal process, a critical component of collateral risk management.

Please provide copies and discuss the contents of this memorandum with your Board and pertinent board committees, your senior management team, your chief appraiser, and other appropriate staff involved in credit risk management or review.

Additional information and answers to appraisal and collateral evaluation frequently asked questions (FAQ) can be found on the FCA’s Web site. We update these FAQs over time as we receive feedback from appraisers, risk and credit managers, examiners, and System institutions. I encourage you to revisit them on the FCA website periodically. If you have any questions about this memorandum, please contact either your designated examiner-in-charge or Hal Derrick, Senior Portfolio Risk Manager and Chief Appraisal Specialist for the Office of Examination at (703) 883-4266 or derrickh@fca.gov.

Attachment

Copy to: Farm Credit Council
Farm Credit Council Services

Attachment

FCA's Expectations for Collateral Risk Management and the Appraisal Process

System institution boards are expected to establish written policies and senior management should develop and implement procedures governing loan portfolio management (LPM). LPM policies and the related procedures should address the identification, reporting and controls for collateral risk in the institution's real estate portfolio. Boards are expected to determine the extent of collateral risk that their respective institutions can prudently accept and the level of reporting on collateral risk that is expected from management. When properly structured, the measurement and management of collateral risk becomes fully integrated into the overall credit risk management process.

We provide the following guidance to facilitate System institutions' compliance with FCA regulations and sound lending and LPM practices. You may expect FCA examiners to apply greater emphasis on the evaluation of these collateral risk issues as part of our ongoing examination of loan portfolio management and credit administration.

FCA Examination of Collateral Risk Management

FCA examiners will request and evaluate the specific information regarding the institution's collateral risk identification, measurement, reporting, and management practices. For example, you may anticipate examiners to:

- Request the institution's analysis and documentation for the level of collateral risk in its portfolio;
- Request documentation of the institution's management controls and servicing procedures for loans with significant collateral risk;
- Review the collateral risk reporting processes at both the board and senior management levels;
- Determine if the board has established risk parameters for collateral risk by loan purpose, portfolio segment, industry, geographic region or any other segment relevant to the institution's loan portfolio;
- Determine if the board has established appropriate direction regarding the amount of collateral risk the institution can prudently accept in its portfolio; and,
- Evaluate the existence and adequacy of specific collateral risk mitigation strategies used by the institution. Examples of these strategies may include the following:
    - meaningful hold limits for individual loan facilities;
    - commodity or industry concentration limits;
    - maximum per unit values (e.g., land values exceeding $10,000 per acre);
    - shortened loan maturities;
    - lower loan-to-value limits by requiring larger down payments;
    - increased payment frequency (e.g., requiring quarterly or monthly payments);
    - increased loan pricing to compensate for higher risk;
    - lower loan-to-value limits on non-income producing properties; and,
    - requiring additional collateral.

Compliance with Basic Appraisal and Collateral Evaluation Principles
The accuracy and support for the underlying collateral values is a critical component of managing collateral risk. Examiners will review appraisals and collateral evaluations to ensure compliance with regulations and sound business practices. In particular, examiners will evaluate whether:

- Consistent with regulatory requirements, each institution has ensured that timely, accurate and appropriate appraisals and collateral valuations based on market value are completed and documented. In a declining market, the institution should determine the appropriate time to re-appraise the real estate, who is qualified to perform the appraisal or collateral valuation, and document any material changes in credit risk resulting from this re-evaluation.
- Each institution ensured the accurate identification of, and the appropriate support for, the "highest and best" use of secured properties is documented in all appraisals or collateral valuations. All System institutions should follow the eligibility and scope of financing guidance provided in FCA Bookletter BL-058 (May 28, 2009) and the safety and soundness guidance for real estate lending provided in Examination Bulletin 2009-2 (December 2009).
- Each institution ensured that appraisals and collateral valuations identify and support the critical factors of market value. These include, at a minimum: (1) the contributory value of all improvements, (2) adequate legal and physical access to the property, (3) the area and neighborhood characteristics that impact marketability of the property and, (4) the description of any easements and/or legal restrictions that could affect the marketability of the property.
- Each institution has ensured that the income producing capacity of secured properties has been properly determined and documented in the loan file and/or appraisal report in accordance with FCA Regulation § 614.4250(a)(6)(i). *(FCA examiners have noted a number of real estate loan transactions where the income producing capacity of the real estate was not determined, or described, as required by this regulation.)*
- Each institution has a process in place to track and document local value trends within their chartered territory. This tracking process should be maintained on a real-time basis and should be supported by analyzed market data.

Appraisals and Collateral Evaluation Reviews
Institutions also must have appropriate control processes in place to ensure accurate identification of values and support for collateral risk management practices. Specifically:

- Each institution should ensure that appraisal and collateral reviews are conducted and documented as part of the institution's internal control program;
- Each institution should ensure that appraisal and collateral reviews are completed by an independent party (functionally independent from the individuals completing the appraisals and collateral evaluations) and that the frequency of reviews are appropriate with the changes in the real estate markets; and,
- Each institution should ensure that appraisal and collateral review conclusions and recommendations are properly reported to either the institution's board and/or audit committee and that all collateral review exceptions are addressed in a timely manner.