Farm Credit Administration

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INFORMATIONAL MEMORANDUM

February 9, 2007

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit Banks and Associations

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

Thomas G. McKenzie

Subject: Significant Asset Growth and Its Implications

The Farm Credit System's (System or FCS) assets grew to $155 billion during the 12-months ending September 30, 2006, an increase of over 14 percent. Loan volume grew by over 12 percent. This represents the System's highest growth rate since 1981.

The purpose of this Informational Memorandum is to alert you to potential implications of significant asset growth that may contribute to increased risk during a less favorable lending environment. Boards of directors, including their audit committees, have primary responsibility for ensuring that their institution's growth is (1) sound, (2) within the institution's risk bearing capacity, and (3) compatible with the System's statutory mandate to serve farmers, ranchers, cooperatives, and other eligible borrowers in rural America. As such, boards of directors should address significant growth rates in their respective institutions and ensure that adequate policies, risk management practices, controls, and reporting are in place to support growth initiatives. More specifically, boards of directors of institutions with significant growth should ensure:

- Underwriting practices are not compromised in the current highly competitive market;
- Loan pricing is adequate to cover risk and maintain profitable interest margins;
- Due diligence and independent credit judgment are exercised when buying participations or taking part in syndications that are led by other lenders;
- Service to production agriculture remains as the primary focus given the GSE mission of the System;
- Out of territory loans/relationships are sound, appropriate and in compliance with regulations;
- Internal audit scopes, including credit reviews, are adjusted to ensure plans, policies, and practices are within the institution's authorities and appropriate for your institution's risk profile and risk bearing capacity; and,
- Reporting to the boards of directors and the Farm Credit Administration (FCA or Agency) is comprehensive, accurate, and complete.

As part of the Agency's strategic oversight, the Office of Examination plans to increase its monitoring and examination of growth and will evaluate the underlying sources and quality of growth in the System. In addition to our examinations of individual institutions, we anticipate conducting a National Examination Activity during 2007 focusing on loan growth and related lending practices.

The addendum to this memorandum includes additional discussion of key issues in the current lending environment that are important for System institutions to consider. Directors and management should ensure they establish appropriate controls to manage resulting implications of asset growth. We suggest you share this memorandum with your credit and risk management officials, conduct discussions with appropriate committees, and develop follow-up actions that may be needed by your institution.

If you have any questions about this Informational Memorandum, please contact David Stephens, at (703) 883-4412, or at e-mail address stephensd@fca.gov or the examiner-in-charge assigned to your institution.

Addendum

Farm Credit Administration
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This addendum provides additional discussion of key factors in the current lending environment that System boards and management should consider as they implement 2007 business plans. Reference to regulatory and examination guidance previously issued by the FCA may also be of help. Should you have questions regarding application of Agency guidance to your institution's specific circumstances, please contact the examiner-in-charge assigned to your institution.

Credit Conditions

The System has greatly benefited from favorable lending conditions for several years. When these favorable conditions come to an end, institutions must be properly positioned for the risk that could follow. From the problems of the 1980s, the agricultural lending industry, and the System in particular, have made a remarkable turnaround. At September 30, 2006, over 96 percent of System loan volume was of Acceptable quality and earnings and capital levels remained sound. Record farm income in 2004 and 2005 has contributed to the System's strong condition. Similarly, land values have increased sharply with a 15 percent increase in 2005, the largest percentage gain since 1981. Significantly, land values have increased by 50 percent over the past three years.

Despite these strengths in the general agricultural economy, institutions must be aware of the threats that could cause their portfolio to deteriorate. For example, agricultural real estate appreciation has been driven in part by non-agricultural factors. As a result, weakness in residential real estate values could spill over into agricultural real estate. This is more likely when the appreciation has exceeded increases in cash rents and the income-producing capacity of agricultural land. We previously cautioned System institutions to be alert to increasing collateral risk in an Informational Memorandum issued on March 9, 2005. Additionally, the current U.S. Department of Agriculture forecast (November 2006) estimates that farmers' net cash income will decrease in part because of an increase in production expenses, particularly fuel and fertilizer expenses. Profitability of poultry and livestock producers is being adversely affected by significantly higher corn prices, which are being driven by the ethanol industry. We comment on ethanol lending and the System's support for that industry in greater detail below. Finally with regard to current credit conditions, the recent record profitability occurred partly because of government support programs that many expect to be reduced in the future. We urge you to monitor anticipated changes in the forthcoming Farm Bill and assess their impact on your portfolio.

Lending Due Diligence

System loan volume has continued to grow very rapidly from many sources, including participation/syndication activity with lenders outside the FCS. Participation and syndication loan volume with non-FCS lenders has risen from about $8 billion to $14 billion in two years. While we encourage this cooperation with non-FCS lenders, when your institutions move away from traditional lending areas you must maintain adequate expertise, lending controls, and underwriting standards and you should exercise appropriate due diligence and independent credit judgment.

Although some System lenders have considerable experience and expertise in participations and syndications, others are relatively new to such transactions. In some instances, these institutions may be tempted to overly rely on the expertise of the lead lender and may be assuming that the risk is being properly managed. Before purchasing a participation interest in a loan or becoming a member of a syndication, System institutions are responsible for making a determination on the creditworthiness of the borrower that is independent of the originating or lead lender and any intermediary seller or broker. Your determination should be supported by a documented due diligence process that considers and addresses each of the potential risks in the transaction. Lenders should use considerable caution before engaging in a loan participation or syndication transaction when they are not comfortable that they fully understand and have addressed the potential risks.

Ethanol Industry

The ethanol industry has been one of the most rapidly growing agricultural sectors and one that the System has played a major role in financing. The ethanol industry is playing a vital role in rural America by providing a key market for corn producers, and a source of new jobs and income, while helping our nation meet its energy needs. Many of the existing ethanol plants have achieved profitability in a short period of time and benefited their owners and local communities. Yet, there are indications that the market is becoming saturated and underlying economics are changing.

We believe the System can continue to play a crucial role in the growth of this industry, which we view as fully within the System's statutory mandate to finance value added agriculture, but System lenders need to carefully assess the risks in financing continued expansion. As with any industry financed, lenders should closely monitor industry conditions. Lenders must ensure such borrowers have strong working capital and reserves, experienced management, efficient operations, and clearly identified markets and sources of production input (e.g. corn, natural gas). System lenders should also establish and implement risk mitigation tools, such as limiting exposure to the ethanol industry as a percentage of risk funds. A review of loan underwriting practices would be appropriate for these type producers and for poultry and livestock producers, whose profitability is being adversely affected by significantly higher corn prices.

Loan Pricing

Lenders must maintain disciplined pricing practices that ensure loans are priced to cover all costs and potential risks. In its October 2006 report on underwriting practices, the Office of the Comptroller of Currency noted continued pricing and loan structure concessions in both syndicated and middle market loans. We also have observed that loan spreads and net interest margins have steadily declined in recent years. Over the past three years, System loan spreads declined more than 50 basis points from 2.28 percent in 2003 to 1.76 percent for the nine months ending September 30, 2006. We are aware that strong competition in the marketplace has contributed to the decline in net spreads. When coupled with rapid growth, the narrowing spreads have started to cause a decline in overall System capital ratios. While capital remains strong, continued rapid growth and narrowing spreads may increase pressure on capital ratios and could be a significant challenge for some institutions.

FCS Mission

System boards and management must continue to ensure that growth is appropriately focused on service to production agriculture. This means institutions must continually push for balance in mission accomplishment to ensure that all segments of the agricultural marketplace receive constructive and needed credit. Meeting those needs does not include non-mission related real estate development or speculative purposes. Such lending practices are not consistent with FCA regulations and may significantly increase risk to the overall favorable reputation enjoyed by the System at large. System lenders must ensure that they maintain sound credit and a sound reputation by focusing on agricultural and rural lending permitted by FCA regulations § 613.3000 and § 613.3005, as was recently clarified by guidance found in Examination Bulletin 2006-2. If your institution is growing at a significant rate, you should be sure that growth is consistent with the FCS mission.

Out-Of-Territory Lending/Relationships

In an environment of significant loan growth, we remind System institutions of the requirements of § 614.4070 of the FCA's regulations. Notice or consent is required for out-of-territory loans. You should monitor out-of-territory lending by your institution and regularly assess its impact on the System as a whole. We encourage you to focus service on your chartered territories and strongly encourage you to work cooperatively with other System institutions in meeting the needs of eligible customers and service to rural America.