LONE STAR Ag Credit

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November 15, 2013

Barry F. Mardock
Deputy Director, Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Via Email

Re: Statement on Regulatory Burden – Federal Register Vol. 78, No. 138 (July 18, 2013)

Dear Mr. Mardock:

I am the Chief Executive Officer of Lone Star, ACA and am writing this letter in response to the Farm Credit Administration's ("FCA") request for comment on certain existing regulations that, among other things, are duplicative, ineffective, not based on the law, or impose burdens that exceed the benefits received. In this letter, I will focus on one regulatory matter that warrants further clarification by the FCA at this time: distressed loan restructuring ("DLR") with regard to matters that involve criminal activity and/or matters that are subject to referral as indicated below.

The Farm Credit Act (the "Act") and the federal regulations promulgated thereunder provide that, when a loan has been identified as distressed by a qualified lender, the qualified lender is required to provide notice of distress and inform the borrower that he or she has the right to request a restructuring of the loan, among other things. *See, e.g.,* 12 USC 2202a § 4.14A(b); 12 CFR § 617.7410(a). "Restructure" and "Restructuring" are defined in the Act to include "rescheduling, reamortization, renewal, deferral of principal or interest, monetary concessions, and the taking of any other action to modify the terms of, or forbear on, a loan in any way ***that will make it probable that the operations of the borrower will become financially viable***." 12 USC 2202a § 4.14A(a)(7) (emphasis added); *see also* 12 CFR § 617.7000.

In reviewing the Act and the regulations with regard to when notice of DLR is required and what a restructure is, it appears that one of the general purposes of DLR is to provide the borrower with an opportunity to return a distressed loan to viability while recognizing the need to protect and preserve the collateral from dissipation, diversion, or deterioration; the opportunity to restructure, however, must be evaluated in light of its cost and support, among other things.

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For example, the Act and the regulations provide guidance on how a qualified lender should evaluate a restructuring application, such as the cost of the restructure on the lender and whether such cost is "equal to or less than the cost of foreclosure" (including the present value of foregone interest and principal and the administrative expenses associated with the borrower's request and application, whether there will be an orderly debt retirement, and whether the borrower has furnished current and complete financials), whether the borrower is applying all income over living and operating expenses, and "[w]hether the borrower has the financial capacity and management skills ***to protect the collateral from diversion, dissipation, or deterioration***." 12 CFR § 617.7415(a)(5) (emphasis added); *see also* 12 USC 2202a § 4.14A(d).

Underlying such criteria is the safety and soundness of the decision by the lender to restructure, which is consistent with one of the stated objectives of DLR: "The objective of distressed loan restructuring action is to return the borrower's operation to viability; therefore, the loan file must contain documentation that the probability of viability was considered." FCA Examination Manual No. EM-623, Published 06/1994. The concept of safety and soundness is found throughout the Act and the federal regulations and is not limited to DLR. Safety and soundness, including the 5 C's of credit and trust, serve as the foundation for the making of a loan.

Recognizing that a qualified lender must proceed in a way that is safe and sound, protects the collateral for the loan, and minimizes the risk of loss and the cost to the association, the Act and the federal regulations provide that there are certain occasions when a qualified lender may take certain actions without first having to provide notice of DLR. For example, 12 CFR § 617.7425(c) provides that: A lender is not prevented "from taking any action necessary to avoid the dissipation of assets or the diversion, dissipation, or deterioration of collateral if the lender has reasonable grounds to believe that such diversion, dissipation, or deterioration may occur." 12 CFR § 617.7425(c); *see also* "Foreclosure Restriction," FCA Examination Manual No. EM-623. The regulations also provide that "[a] qualified lender may not require a borrower to reduce the outstanding principal balance of a loan by any amount that exceeds the regularly scheduled principal installment when due and payable ***unless***...[t]he borrower sells or otherwise disposes of part, or all, of the collateral without the prior approval of the qualified lender and the proceeds from the sale or disposition are not applied to the loan...." 12 CFR § 617.7400(b). Thus, if a qualified lender learns that a borrower is selling collateral out of trust, *e.g.*, a qualified lender may take action against the borrower or with regard to the collateral to minimize the loss to the association without first having to provide notice of DLR. Such actions include filing an application for and obtaining injunctive relief, pursuing self-help repossession, and making a referral,[1] as appropriate. If a qualified lender fails to take prompt action to protect the collateral and/or minimize the risk of loss to the association (*e.g.*, if a qualified lender waited to first provide notice of DLR before proceeding to take actions to protect the collateral and to minimize the risk of loss), then the association may be forced to incur a loss that could have been avoided.

[1] The concept of taking prompt action in the event of diversion or dissipation, *e.g.*, is consistent with the short timeframe for making a referral. *See, e.g.,* 12 CFR §§ 612.2300, *et seq.*

Although the regulations and/or the Act provide guidance on when a qualified lender may take action without having to first provide notice of DLR to the borrower, the authorities need to be clarified and/or expanded to recognize and take into account that the purpose of DLR and safety and soundness are not, and cannot be, satisfied with a borrower who engages in criminal activity or who diverts, wastes, or dissipates collateral even after the immediate threat to the collateral has been addressed.

Specifically, the Act and/or the regulations provide that when collateral may be dissipated, deteriorated, or diverted, a qualified lender may take certain actions to protect the collateral or minimize loss without first satisfying DLR. However, harm to collateral should not be the only exception specifically identified in the regulations. If a borrower has provided false financial information, made a false statement on his or her application, obtained a loan under false pretenses, misapplied fiduciary property, engaged in money laundering, and/or engaged in other criminal activity that impacts the trust relationship or constitutes fraud,[2] then a qualified lender should not be required to afford such a borrower an opportunity to restructure the loan – *i.e.*, return the loan to viability. Under such circumstances, regardless of how well-secured the loan may be, the trust critical to the lending relationship no longer exists (and, in fact, may have never existed), the loan cannot be returned to viability, the criteria for evaluating a restructuring application from such a borrower cannot be satisfied, and the delay in proceeding to judgment, accelerating the maturity date, or taking other actions permitted by law solely to satisfy the DLR process exposes the association to harm and loss – all to the detriment of the other borrowers of the association and the system as a whole – without any tangible benefit to the association.[3]

Further, if the qualified lender is able to repossess the remaining collateral and apply the proceeds to the outstanding indebtedness, then the loan may no longer secured and/or there may not be any loan to restructure any way. Arguably, once all actions have been taken by the qualified lender to protect against dissipation or deterioration of the collateral as permitted by the regulations, the qualified lender could provide notice of DLR to the borrower. However, doing so would be symbolic or for process only and would serve no benefit either to the borrower or the qualified lender for at least the reasons set forth above. Instead, the Act and/or the regulations should be clarified that, if a borrower engages in criminal activity or if the collateral has been diverted, disposed of, or wasted, then a qualified lender is not required to provide notice of, or satisfy, DLR. The clarification or expansion being requested is distinguishable from a situation where a qualified lender suspects that a borrower has engaged in criminal activity but has no proof or evidence to support its suspicion and/or if the collateral has been harmed as a result of third party actions unrelated to the borrower.

The DLR process serves a valid purpose for honest borrowers whose loans have been identified as distressed within the meaning of the Act and the regulations. However,

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[2] Such acts shall be referred to as "criminal activity" for purposes of this letter.

[3] This concept is consistent with the notion that, if a contract is procured by fraud, the defrauded party may seek to rescind the contract.

the circumstances under which a qualified lender is not required to afford the borrower with an opportunity for DLR should be clarified or expanded beyond diversion, deterioration, or dissipation of collateral because those are not the only circumstances under which a qualified lender is faced with a loss of trust or a risk of harm or loss to the association; indeed, the actual criminal act that triggers the loss could be entirely independent of the collateral issue altogether. In addition to the exceptions currently found in the Act and the regulations, a qualified lender should not required be required to offer DLR to a borrower who has engaged in criminal activity, such as fraud, false statements on an application, false financial information, misapplication of fiduciary property, and other similar acts that impair or destroy the trust relationship critical to making safe and sound loans. Instead, a qualified lender, under such circumstances, should be able to take actions necessary to protect the collateral and minimize the loss to the association without having to offer an opportunity for DLR to the borrower first.

The clarification or guidance I am requesting only serves to further the charge and goals that are found throughout the Act and the regulations, including the purpose of ensuring "public confidence in the Farm Credit System,... to reduce potential losses to institutions, and to ensure the safety and soundness of institutions," 12 CFR § 612.2300(a), the objective to "provide full credit, to the extent of creditworthiness," 12 CFR § 613.3005, and to "maintain high standards of industry, honest, integrity, impartiality, and conduct in order to ensure the proper performance of System business and continued public confidence in the System and each of its institutions" and to "exercise diligence and good judgment in carrying out their duties, obligations, and responsibilities." 12 CFR § 612.2135; *see also* 12 CFR 612.2165(b)(1).

Thank you for this opportunity to provide our comments on the DLR authorities. If you have any questions or would like to discuss these matters further, then please do not hesitate to contact me at (817) 332-6565.

Sincerely,

Steven H. Fowlkes
Chief Executive Officer, Lone Star, ACA