Farm Credit Administration

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INFORMATIONAL MEMORANDUM

February 11, 1999

To: The Chief Executive Officer
All Farm Credit System Institutions

From: Roland E. Smith, Director /s/
Office of Examination

Subject: Loan Pricing by Farm Credit System Institutions

Recently, the Farm Credit Administration (FCA) has received inquiries from several Farm Credit System (FCS or System) institutions relating to the Office of Examination's (OE) approach in examining the loan pricing practices of System institutions. In addition, the FCA has received a number of letters related to the loan pricing practices of System institutions. Many of the letters were complaints from commercial banks alleging that System institutions are pricing loans below competitive interest rates within their local markets. This memorandum discusses how the OE examines an institution's loan pricing practices. In addition, attached is a summary in a question-and-answer format that addresses many of the most commonly asked questions related to loan pricing and regulatory requirements.

The Farm Credit Act provides that it shall be the objective of FCS institutions to set interest rates and other charges at the lowest reasonable cost on a sound business basis. Consistent with the law, regulations and sound business practices, System institutions should price loans at a level sufficient to cover all costs, fund provisions to the allowance accounts, and accumulate capital. Specific consideration should be given to the cost of funds, the cost of servicing loans, other costs of operations, interest rate risks, profit and marketing objectives, and the competitive environment. In addition, an assessment of the degree of credit risk evident in individual loans should be a principal component of an institution's loan pricing program.

Each FCS institution should have a written policy that directs and controls loan pricing decisions. At least annually (and more frequently if needed), each institution's board should review its loan pricing policy for continued appropriateness, compliance with applicable law and regulation, consistency with the institution's objectives, and achievement of desired results. You should ensure that the analysis used in loan pricing decisions is well documented.

Through the examination process, the OE will continue to review each institution's loan pricing philosophy, policy, and practices. Examiners will evaluate whether interest rates charged are consistent with established policies and are sufficient to cover costs and adequately capitalize the institution, while maintaining safety and soundness and remaining competitive in the marketplace. Examiners will also evaluate whether institutions support loan pricing decisions with thoroughly documented analysis of all factors considered in the loan pricing process. In most cases, this documentation should include an analysis or survey of the institution's competitive environment. Examiners will focus on loan pricing that appears to be outside of prevailing market interest rates to determine the reasons for such practices, as this could be an indication of pricing deficiencies, particularly if the institution has other financial weaknesses. We recognize that institutions desire to set interest rates at levels to attract or retain borrowers. In doing so, it is imperative to adequately cover the costs of doing business and follow safe and sound banking practices.

We encourage you to review this memorandum and attachment and discuss it with your board and appropriate staff. If you have questions, please call me at (703) 883-4160 or Thomas Holland, Director, Special Examination and Supervision Division in the Office of Examination, at (703) 883-4483. Also, please feel free to correspond with us directly on the Internet at e-mail addresses *smithr@fca.gov* and *hollandt@fca.gov.*

Attachment