Farm Credit Administration

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INFORMATIONAL MEMORANDUM

May 11, 2006

To: Chief Executive Officer
All Farm Credit System Institutions

From: Charles R. Rawls, General Counsel
Office of General Counsel

Subject: Clarification of FCA Regulation 614.4200(b)(1) – Security for Long-Term Loans

Purpose of this Informational Memorandum

The purpose of this Informational Memorandum is to clarify Farm Credit Administration (FCA) regulation 614.4200(b)(1) to ensure that it is interpreted consistently throughout the Farm Credit System (System). We note at the outset that this Informational Memorandum only clarifies the collateral requirements in §614.4200(b)(1). Prior to considering the collateral requirements for a loan, a System institution must first determine that the borrower is eligible for financing and that the loan meets scope of financing requirements. The following discussion is consistent with the explanation contained in the preamble to the final rule (published in the *Federal Register* on September 30, 1997) 62 *Fed. Reg.* 51007 and provides further guidance on the proper interpretation.

The Regulation

12 C.F.R. § 614.4200(b)(1) provides:

> Long-term real estate mortgage loans must be secured by a first lien interest in real estate, except that the loans may be secured by a second lien interest if the institution also holds the first lien on the property. No funds shall be advanced, under a legally binding commitment or otherwise, if the outstanding loan balance after the advance would exceed 85 percent (or 97 percent as provided in section 1.10(a) of the Act) of the appraised value of the real estate, except that a loan on which private mortgage insurance is obtained may exceed 85 percent of the appraised value of the real estate to the extent that the loan amount in excess of 85 percent is covered by such insurance. The real estate that is used to satisfy the loan-to-value limitation must be comprised primarily of agricultural or rural property, including agricultural land and improvements thereto**,** a farm-related business, a marketing or processing operation, a rural residence, or real estate used as an integral part of an aquatic operation.

There are two areas of the regulation that we are clarifying:

(1) What kind of property satisfies the “agricultural or rural property” collateral requirements?

(2) How much additional non-rural, non-agricultural property can an institution take as collateral?

Agricultural or Rural Property

The regulation states that security taken must consist primarily of agricultural or rural property “including agricultural land and improvements thereto**,** a farm-related business, a marketing or processing operation, a rural residence, or real estate used as an integral part of an aquatic operation.” This list contains illustrative examples only; this list is not intended to be an exclusive list. The word “including” means that what follows is part of a larger whole.

Section 1.7 of the Farm Credit Act of 1971, as amended (Act), authorizes System lenders to make and participate in “long-term real estate mortgage loans in rural areas, as defined by the Farm Credit Administration . . . .” We did not intend §614.4200(b)(1) to be more limiting than the Act, and we did not intend for anyone to infer that we considered the five examples of “rural” property in § 614.4200 to be our definition of “rural” property. FCA has not defined “rural” for purposes of a System institution making long-term real estate mortgage loans, except for purposes of rural housing loans. The 2,500 population limit found in FCA regulation 613.3030 (and § 1.11(b) of the Act) applies only to rural housing financing to rural residents and not to an institution’s general authority to make mortgage loans. FCA regulation 613.3030 provides that rural housing loans may be made to a “rural homeowner,” which is defined as “an individual who resides in a rural area and is not a bona fide farmer, rancher, or producer or harvester of aquatic products.”

Therefore, in the absence of an applicable definition of “rural” in the Act or our regulations, FCA uses the common, ordinary, everyday meaning of the word “rural” in applying § 614.4200. Because the word “rural” is defined many different ways in common usage, we consider a System institution to be in compliance with the “rural property” requirement of § 614.4200(b)(1) if it can objectively demonstrate that the property is “rural” in nature under a reasonable interpretation of that term. For example, an institution could establish the rural nature of an area by reference to an authoritative statistical source such as the United States Census Bureau or the United States Department of Agriculture. The USDA defines "rural" a variety of ways depending on the context and purpose of the definition, ranging from areas with populations of 2,500 to areas with populations of 50,000. Any numerical population limit relied on by System institutions to determine the "rural" nature of a given property needs to be objectively reasonable considering the specific geographic location and use of the property. An institution could also demonstrate the “rural” nature of a given property by other objectively reasonable indicia, which may be specific to a given geographic area (such as a reasonably defined small community within the formal boundaries of a populous county or city). Additionally, we consider property to be “agricultural” for purposes of § 614.4200, regardless of geographic (or "rural") location, if the institution can reasonably demonstrate a substantive link between the property and the borrower’s agricultural operations. In addition, if property was objectively determined to be rural based on a reasonable interpretation, such as use of a Census Bureau index, and the population of the area changes such that it is no longer in a rural area, an association may

continue financing the subject property as long as it has a continuing financing relationship with the borrower on that property. In other words, an association may refinance or extend additional credit on the same property.

Additional Collateral

Section 614.4200(b)(1) provides that the real estate "used to satisfy the loan-to-value (LTV) limitation must be comprised primarily of agricultural or rural property . . ." However, that does not mean that the collateral package as a whole must "primarily" consist of agricultural or rural property. As discussed in the preamble to this rule, more than 50 percent of the collateral "used to satisfy" the 85 percent LTV requirement must be agricultural or rural property. The remaining "additional security" necessary to reach an 85 percent LTV may be non-agricultural or non-rural property and may have a value in excess of the agricultural or rural property. This is made clear in the preamble to the final rule, which provides: "if the value of the nonagricultural or non-rural property taken as additional collateral is greater than the value of the collateral taken to meet the loan-to-value limitation, the excess value of such additional collateral will not result in a violation of this section."

For ease in meeting this regulatory requirement, System institutions may use the following formula:
Agricultural or Rural Property Must Be Greater Than (Loan Amount ÷ .85 × .50)

For example, an applicant seeking a $340,000 loan to purchase property needs $400,000 in collateral to satisfy the 85 percent LTV requirement. The agricultural or rural property needs to consist of greater than 50 percent of that amount, which is $200,000. ($340,000 ÷ .85 × .50 = $200,000) In addition to the required amount of agricultural or rural property collateral (greater than $200,000), the institution can take any amount of other property as collateral to result in a sound loan package.

Please contact Howard Rubin, Office of General Counsel, at (703) 883-4029 or rubinh@fca.gov or Barry Mardock, Office of Regulatory Policy, at (703) 883-4456 or mardockb@fca.gov if you have questions regarding this Informational Memorandum.