AGRICULTURAL LENDING

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Reference Material

FDIC Examiners should reference FIL-39-2014 *Prudent Management of Agricultural Credits Through Economic Cycles* for general policy direction on analyzing agricultural credits. Federal Reserve Examiners should reference SR 11-14 *Supervisory Expectations for Risk Management of Agricultural Credit Risk.*

Policy Considerations

1. Determine whether policies are appropriate for the bank's agricultural lending activities and risk profile. Consider whether policies address:

- **Agricultural loan structuring;**
- **Underwriting standards;**
- **Guidelines for evaluating borrower creditworthiness, such as the assessment of borrowers' cash flow, repayment capacity, projected and actual income and expenses, working capital adequacy, supplementary sources of income, and debt service coverage;**
- **Collateral margins for specific types of agricultural lending, such as dryland, irrigated, or pasture; livestock; machinery and equipment; vehicles;**
- **Documentation and appraisal requirements;**
- **Procedures for identifying existing and potential environmental concerns;**
- **Guidelines for on-farm inspections, such as crop and livestock inspections;**
- **Budget monitoring;**
- **Crop insurance;**
- **Cash margins;**
- **Procedures for monitoring hedging strategies, forward contracting, third party contracts, and timing of cash market sales;**
- **Identification/verification of third-party financing;**
- **Workout strategies for problem borrowers and guidance on:**
    - **Renewing or extending loan terms,**
    - **Extending and documenting additional credit,**
    - **Restructurings with or without concessions (troubled debt restructure reporting), and**
    - **Identifying carryover debt and documenting repayment plans.**

2. Determine whether policies establish appropriate lending concentration limits. Consider whether the policy includes:

- **Aggregate concentration thresholds for agricultural lending; or**
- **Stratification thresholds for general Call Report categories, such as Secured by Farmland and Agricultural Loans, or specific categories, such as:**

- **Crops;**
- **Cattle (herd, feeder, backgrounding, feedlot, or dairy operations);**
- **Swine (farrowing or finishing operations);**
- **Poultry;**
- **Land type (dry, irrigated, or pasture land);**
- **Machinery and equipment; and**
- **Geographic location of borrowers or operations (e.g., county or bank branch).**

3. Determine whether policies establish adequate expectations for ongoing monitoring and reporting of portfolio conditions and concentration levels. Consider whether the policy:

- **Requires specific reporting of compliance or noncompliance with policy guidelines,**
- **Requires reporting of the reasons for any noncompliance with policy guidelines, and**
- **Addresses frequency of reporting.**

Loan Administration

4. Assess procedures for monitoring agricultural markets and industry factors that may influence the financial condition and repayment ability of agricultural borrowers, such as:

- **Input costs (seed, feed, fuel, pesticides, land rent, and machinery/equipment);**
- **Farmland and machinery values;**
- **Commodity prices;**
- **Government programs (Conservation Reserve Program, farm subsidies, crop insurance); and**
- **Weather trends.**

5. Determine whether management appropriately evaluates and monitors the managerial capabilities of agricultural borrowers. Determine whether management considers a borrower's:

- **Use of break-even analysis,**
- **Marketing plans (including use of advisors), and**
- **Discipline concerning personal living expenses if loan proceeds fund personal living expenses in part or whole.**

6. Assess controls designed to ensure that loan disbursements are monitored and appropriately documented and that collateral sale proceeds are appropriately applied. Consider the bank's timing and documentation of inspections and the matching of receipts/expenses to budget.

7. Consider whether loan terms are appropriately matched to loan types,[1] by considering:

- **Loan purpose:**
  - **Farmland loans generally amortize over 15 to 30 years,**
  - **Major real estate improvements (such as livestock-confinement buildings and grain-handling facilities) commonly amortize over 15 years or less,**
  - **Machinery and equipment loans often amortize over 5 to 7 years;**
- **Timing of revenue streams:**
  - **Loan payments and maturities generally correspond to the receipt of revenues, growing seasons, useful-lives of collateral, etc.;**
- **Term loan payments:**
  - **Payments generally coincide with livestock or crop sales;**
- **Third-party financing[2] (a/k/a split-line borrowing arrangements):**
  - **Banks typically expect loan customers to keep them informed of such borrowings to ensure management can properly analyze collateral margins and global cash flows.**

8. Determine whether the bank has specific procedures for structuring, approving, and reporting carryover debt. Consider the adequacy of:

- **Note terms and collateral requirements;**
- **Controls for documenting, monitoring, and reporting individual-borrower carryover debt; and**
- **Tracking and reporting carryover debt in the portfolio.**

9. Determine the percentage of the agricultural loan portfolio that is supported by credit enhancements, such as:

- **Farm Service Agency (FSA), Small Business Administration (SBA); Federal Agricultural Mortgage Corporation (Farmer Mac) programs; or**
- **State-level programs, including guarantees, deposit-link arrangements, interest rate buy-downs, and specialized tax incentives.**

10. Assess management's process for monitoring compliance with servicing requirements to determine whether guarantees remain valid.

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[1] **Amortization periods for term indebtedness should correlate with the useful economic life of underlying collateral and the operation's debt service capacity.**

[2] **Credit availability from equipment dealers, vehicle dealers, input suppliers, etc., is prevalent. In practice, banks extending operating credit lines are often expected to advance funds to cover third-party loan payments; however, banks that do so before the season's final cash flow posture can be reasonably known may be subject to greater repayment risk.**

11. Review the adequacy of policies and procedures for monitoring collateral values and margins by considering:

- **The frequency of on-site inspections and the adequacy of appraisals/valuations of real estate, machinery, equipment, livestock collateral;[3] and feed and grain collateral;[4] and**
- **The appropriateness of hedge-monitoring practices (for example, by reviewing broker statements).**

Credit Analysis

12. Assess underwriting practices by considering whether:

- **Cash flow analysis encompasses the borrower's global operations (including estimated family living expenses and reasonable capital expenditures);**
- **Cash flow projections use supportable production yields and price assumptions;**
- **Operating income/expense projections realistically compare to historical averages;**
- **Baseline cash flows are evaluated using modified/stressed projections for key variables, such as input costs, interest rates, yield assumptions, and sale prices.**

13. Determine whether management conducts adequate financial analysis of agricultural borrowers by reviewing the bank's processes for:

- **Calculating changes in earned-equity positions and determining the reason(s) for adverse changes;**
- **Assessing borrowers' tax returns;[5]**
- **Adjusting and documenting machinery and equipment values (e.g., auction price databases);**
- **Analyzing and documenting significant changes in balance sheet values or composition;[6] and**
- **Ensuring credit scoring models accurately identify risk levels and assign internal credit grades.**

DOCUMENTATION

14. Determine whether credit file documentation contains applicable items such as:

- **Property descriptions and collateral values;**
- **UCC filings (verified with regular UCC lien searches);**
- **Notifications to buyers of agricultural products (per state rules);**
- **Real estate and personal property tax-payment status;**
- **Credit bureau reports and material leases; and**

[3] The recommended frequency of collateral inspections varies depending on state lending limit compliance, whether the livestock is part of a breeding herd or fed-slaughter operation, and the location and inventory turnover rate.
[4] Valuations may be based on the local cash price, the value of the hedged positions, or forward contracted prices.
[5] Note that agricultural tax returns are often prepared on a cash basis. Additionally, operators may delay sales and/or prepay expenses to manage tax expenses, and adjustments for inventory changes may be necessary to assess profitability.
[6] For complex multi-crop operations, consider processes for evaluating end of crop cycle actual prices, expenses, and yields as compared to the original crop budget to assess the accuracy of borrower assumptions.

- **Assignments of government farm program payments, crop insurance, and hedge accounts.**

15. Assess real estate appraisals/evaluations. Consider the following items:

- **Soil types, quality, and topography;**
- **Underground or surface water availability or restrictions;**
- **Crop production information;**
- **Inclusion/exclusion of improvements or personal property (e.g., irrigation equipment);**
- **Sales approach – recency of comparable sales, similar parcel types, reasonable adjustments;**
- **Income approach – reasonable income and expenses, capitalization rates that are supported; and**
- **Environmental risk assessment, as applicable.**

WORKOUT STRATEGIES

Many borrowers that experience financial difficulties may be credit worthy customers with a willingness and capacity to repay their debts. Prudent loan workouts are often in the best interest of the bank and borrower. Sound workout strategies include renewals and restructurings that are designed to improve prospects for repayment of principal and interest and are consistent with sound banking, supervisory, and accounting practices.

Renewed or restructured loans to borrowers who have the ability to repay their debts under reasonably modified terms should not be subject to adverse classification solely because the value of the identifying collateral has decreased to an amount that is less than the loan balance.

16. Determine whether management develops comprehensive loan workout strategies for agricultural borrowers experiencing declining cash flows, collateral values, or commodity prices.

17. Determine whether management appropriately considers issues such as the borrower's financial condition and repayment capacity, guarantor(s) financial support, and the value of existing or additional pledged collateral when implementing workout strategies.

18. Determine whether management ensures carryover debt, if any, is appropriately identified,[7] explained, segregated, and addressed in a prudent manner.

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[7] Carryover debts must be clearly identified in loan files, whether rolled into new or existing notes or written into a separate note. In general, carryover debt should be segregated, secured with additional collateral if possible, and amortized over a reasonable term that is consistent with the borrower's repayment capacity.

THIRD-PARTY RISK
19. Assess the bank's risk management strategies designed to control third-party risk by considering: • **Contingency plans designed to mitigate concentration risks if adverse market conditions emerge;** • **Credit file documentation standards that require identification of significant third parties that provide services to, or purchase products from, the borrower;** • **Procedures for assessing the type and volume of business conducted with significant third parties;** • **Limits and monitoring procedures regarding aggregate direct and indirect exposures;[8] and** • **Due diligence procedures for these third parties.**
End of Core Analysis.

[8] For example, if the bank makes a $1 million direct loan to a supplier that also received $10 million in prepaid expenses from farmers financed by the bank, there is a total of $11 million direct and indirect exposure to that dealer.