Farmland Values and Collateral Risk Guidance

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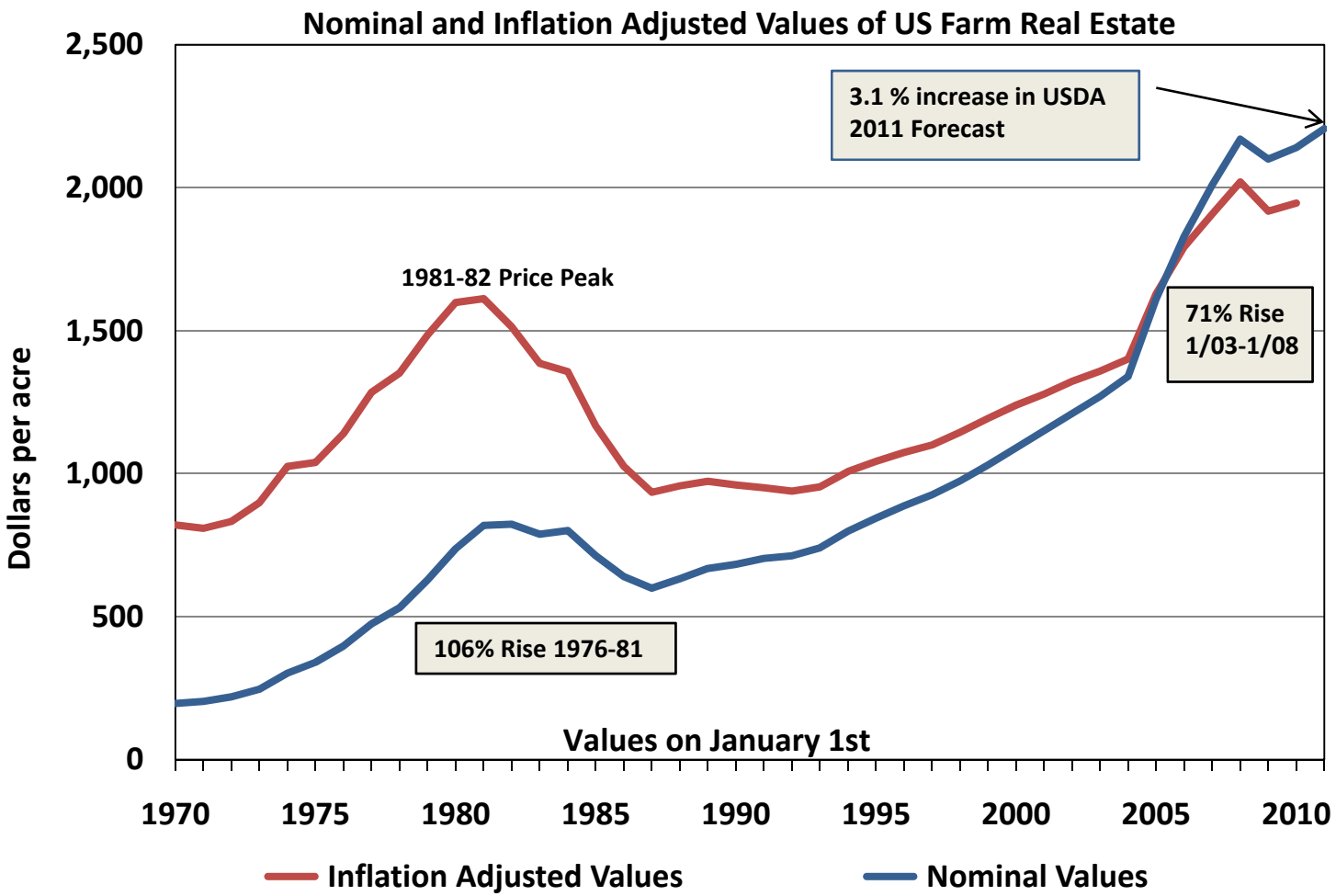
Agenda

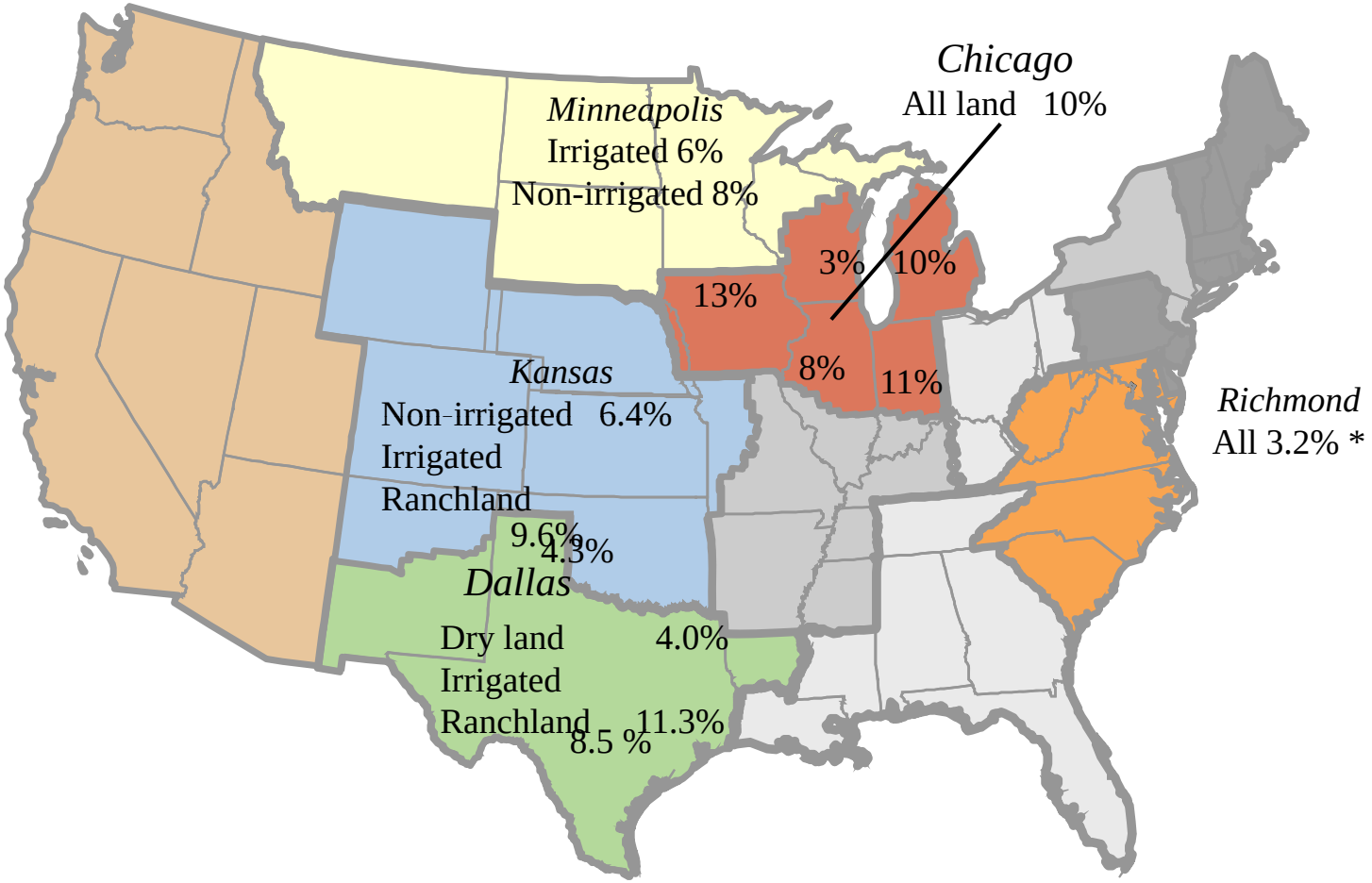
- Farm real estate price and debt trends
- Drivers and risks for farm real estate
- FCA collateral risk guidance
- Future activities

Long-Term National Trend in Farm Real Estate Prices



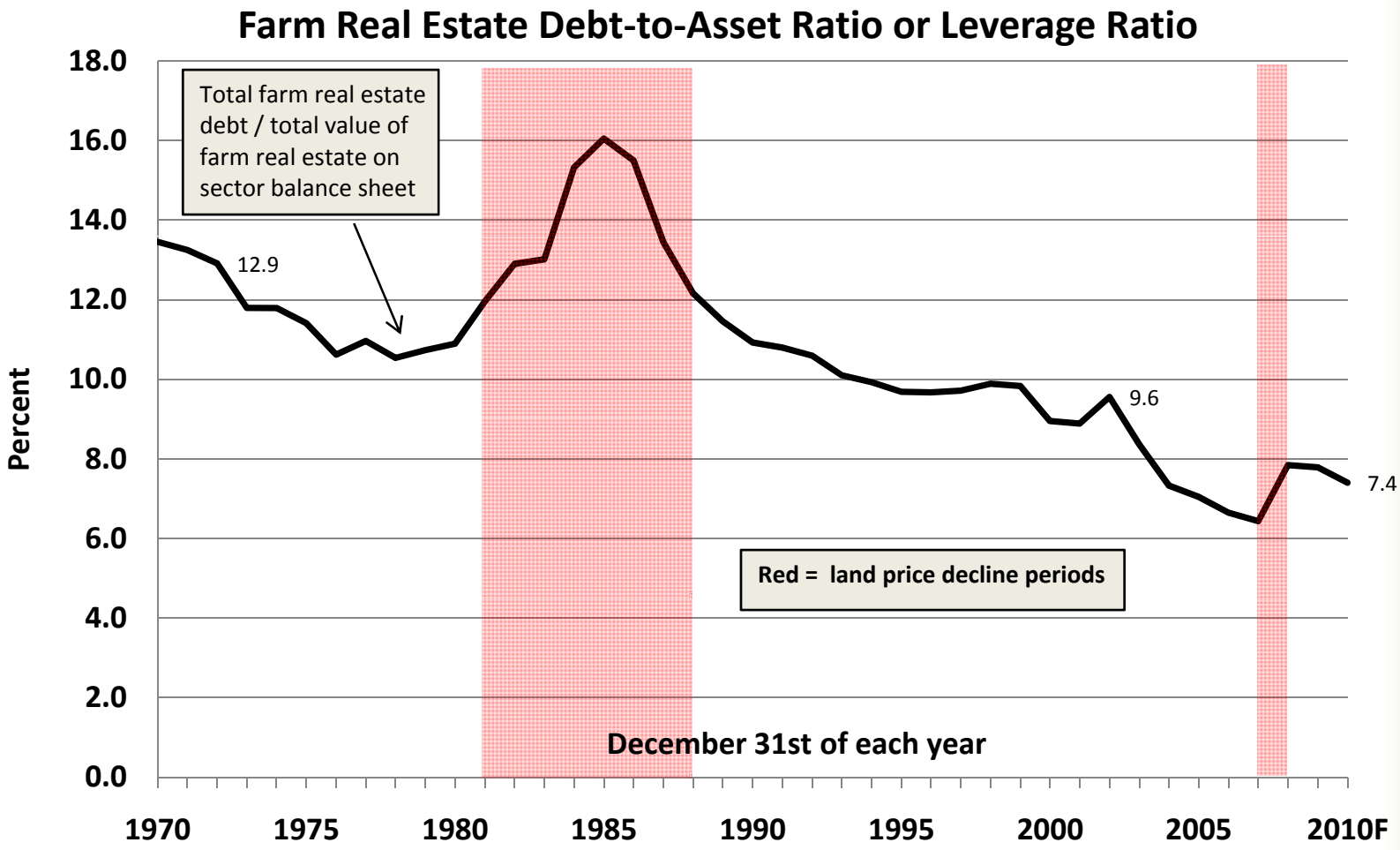
Source: FCA/ORP chart derived from USDA data. GDP Deflator 2005=100.

Annual Cropland Appreciation Reported in 3rd Qtr 2010 Federal Reserve Surveys



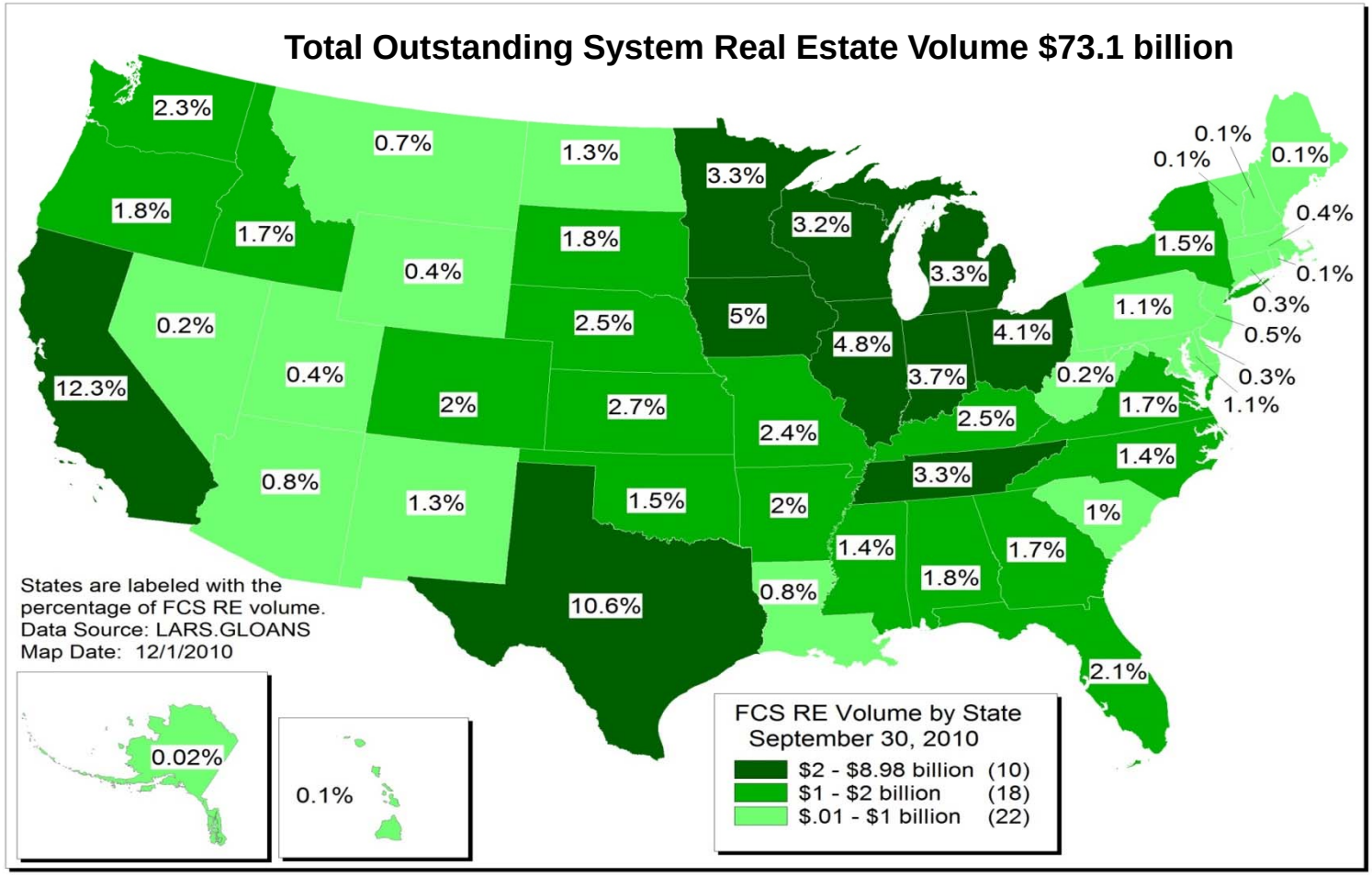
Annual percent changes are 3rd Q 2010 over 3rd Q 2009, except in Minneapolis where it is 2nd Qtr. 2010 over 2nd Qtr. 2009.
*Numbers for the Richmond districts are computed from small samples, thus reported values may vary significantly.
Data sources: Regional Federal Reserve Bank surveys of commercial bankers .

Debt Owed on Farm Real Estate

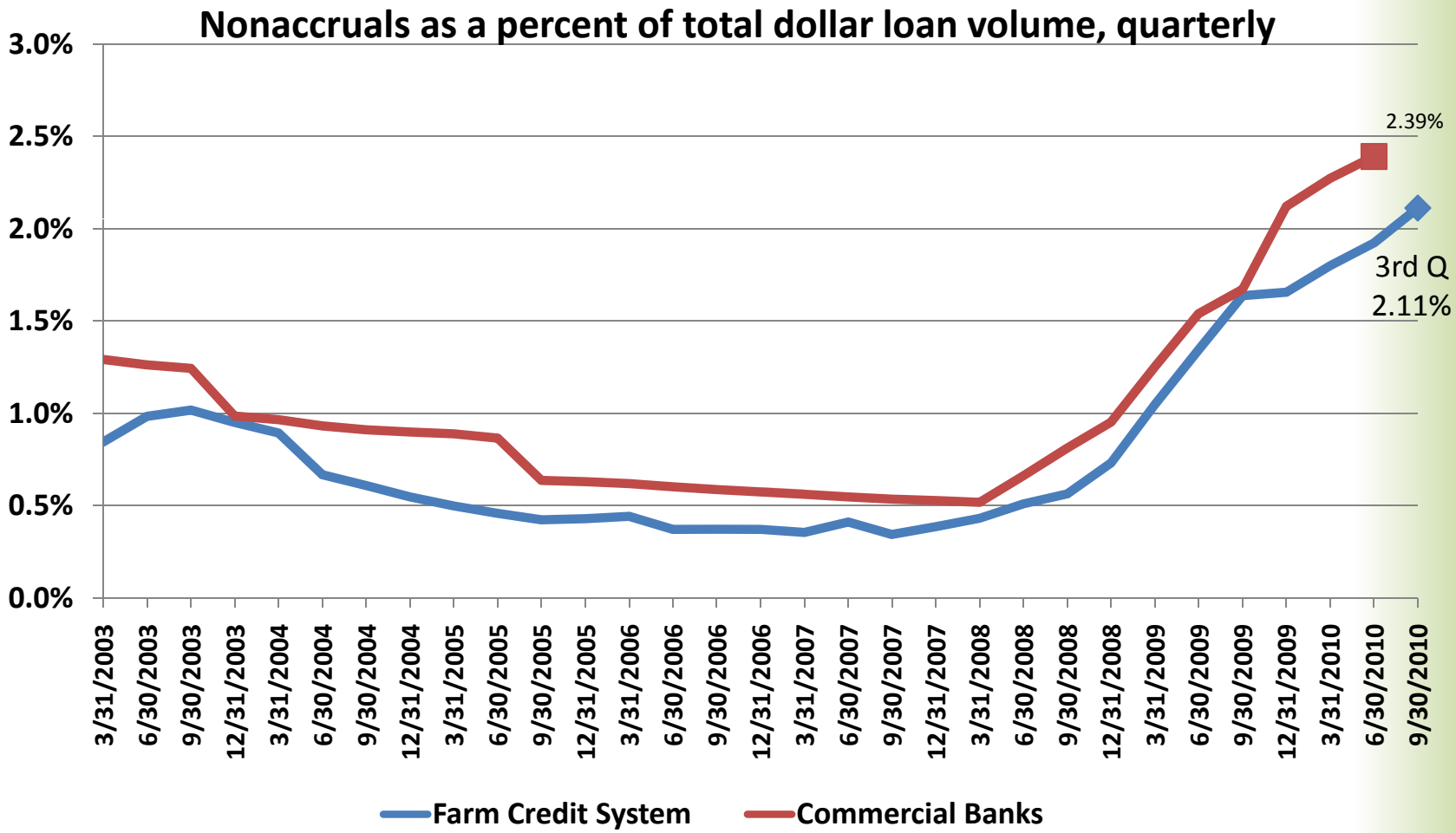


Note: this measure includes all farm real estate, regardless of whether debt is owed.
Source: FCA/ORP chart derived from USDA data.

Concentration of System Real Estate Debt by State as of September 30, 2010

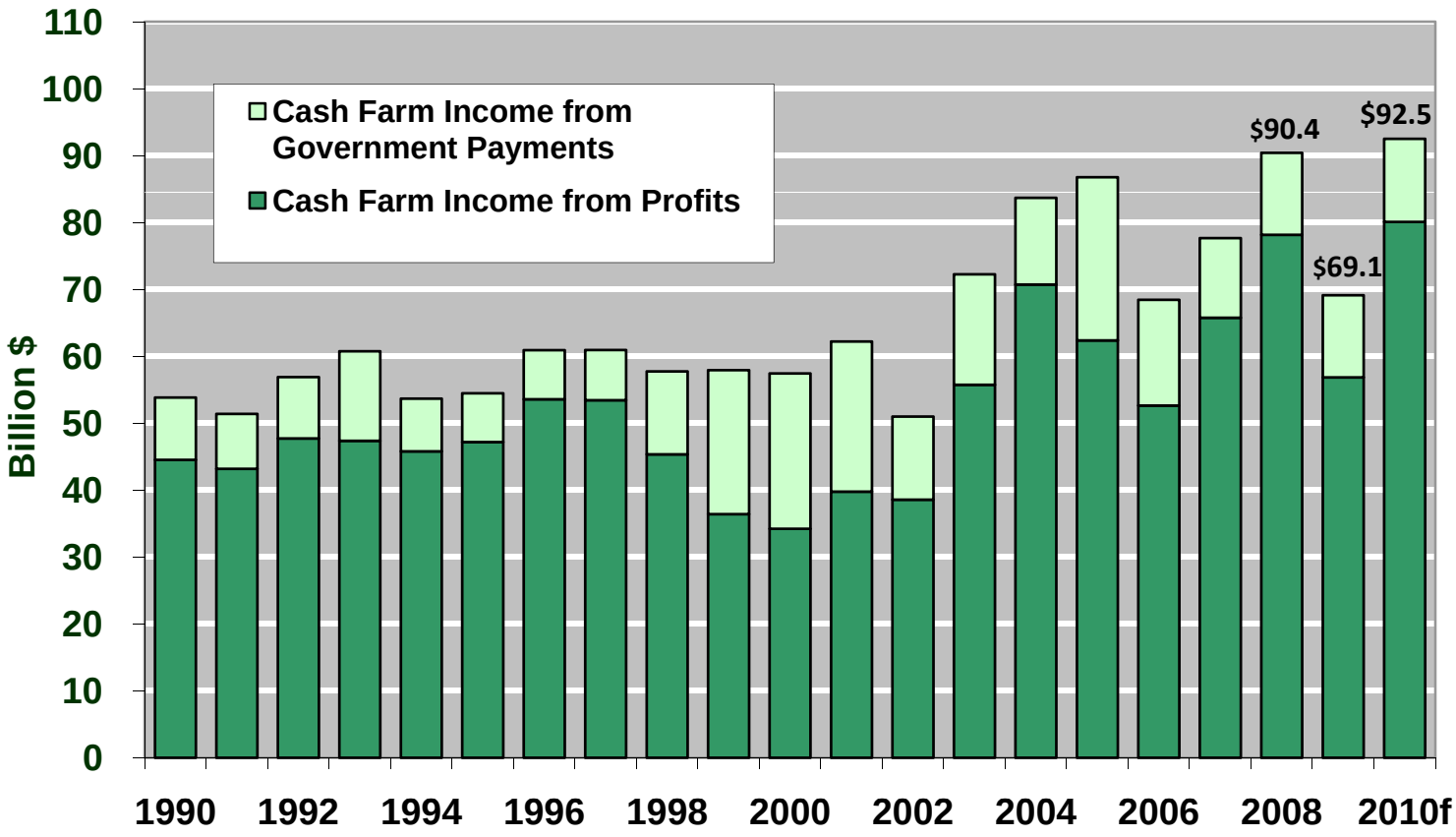


Farm Real Estate Nonaccruals at Commercial Banks and the System



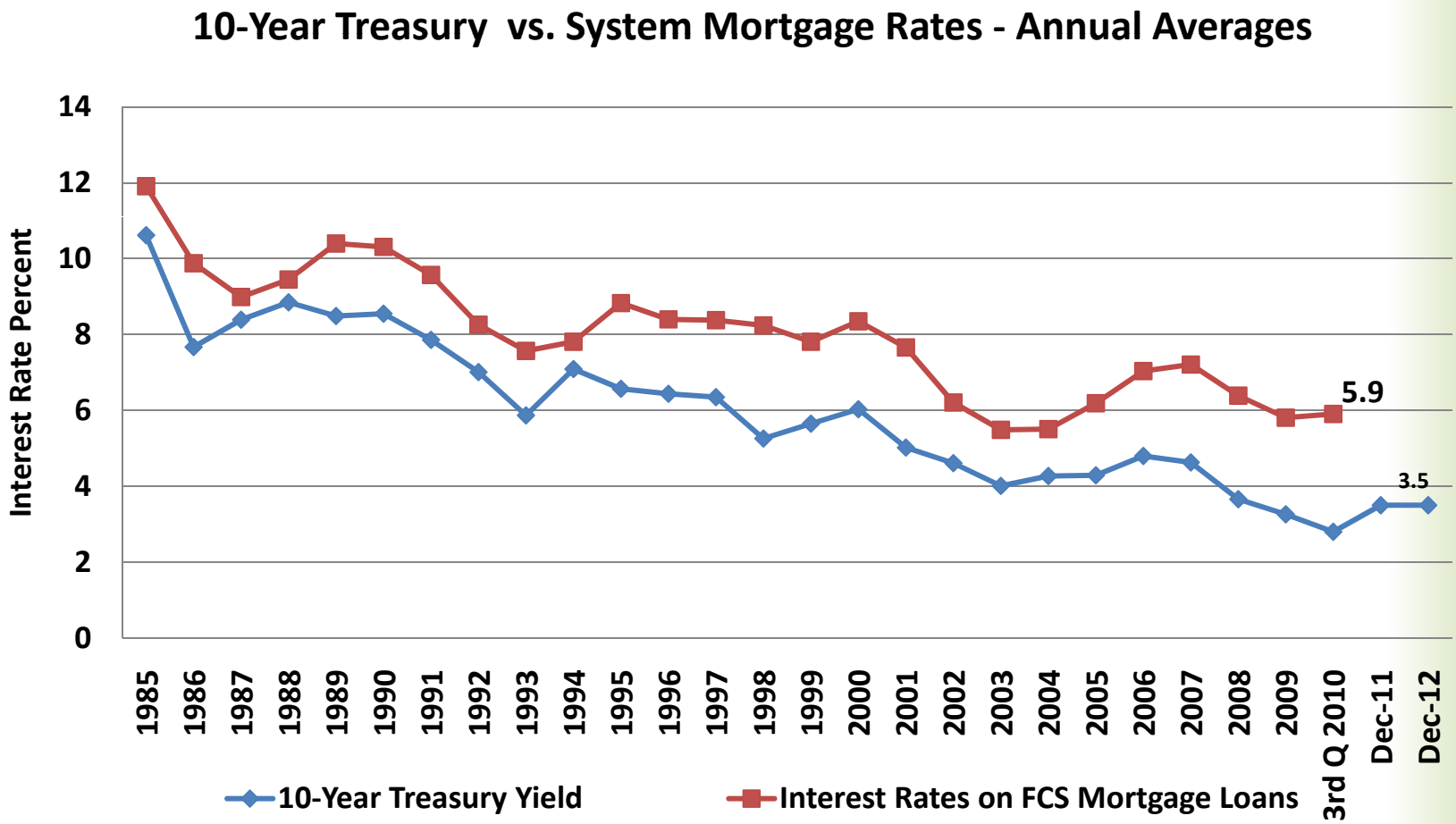
Source: FCA/ORP chart derived from FCA Call Reports and the Board of Governors of the Federal Reserve System.

Driver: Total Net Cash Farm Income



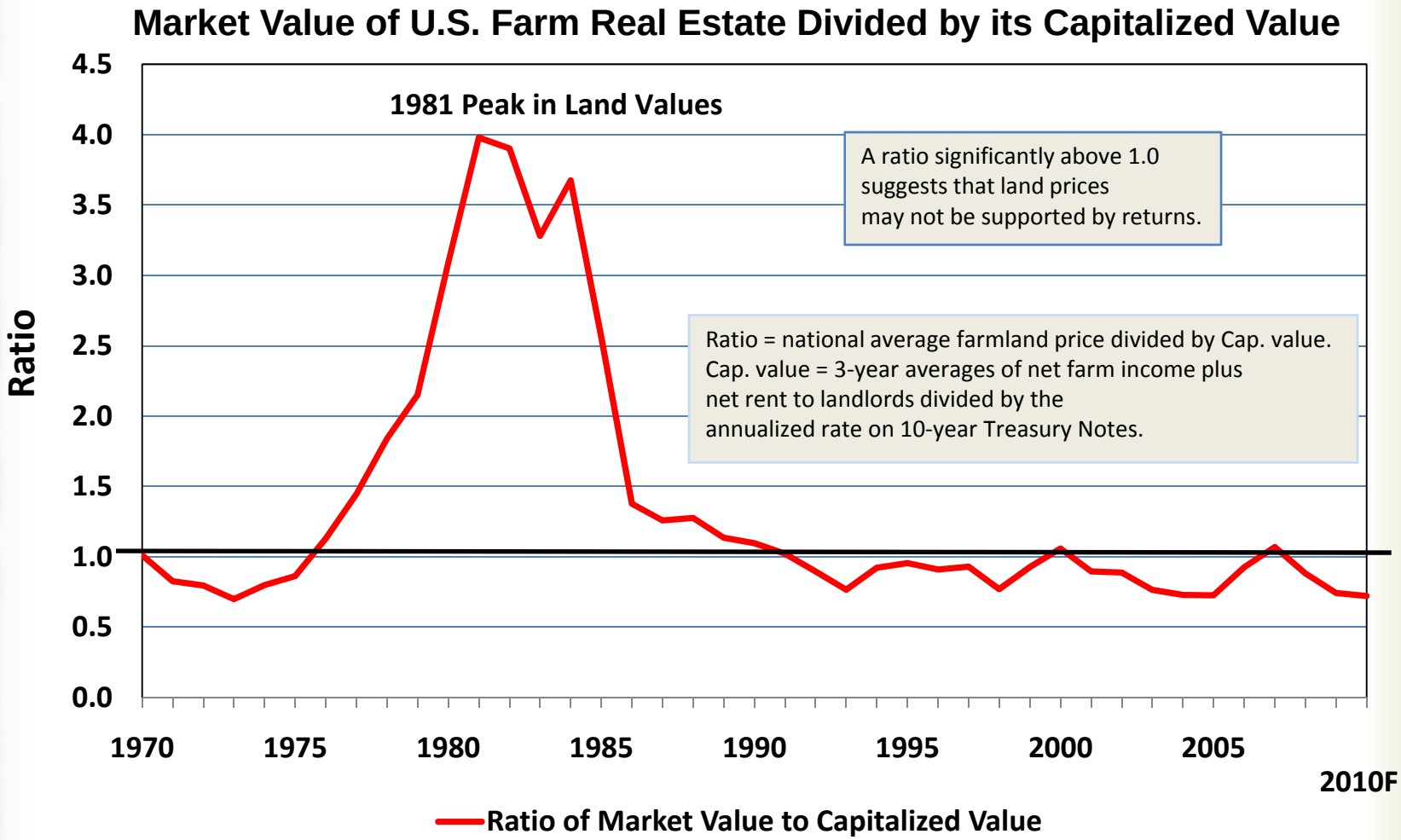
Source: FCA/ORP chart derived from USDA Data; Forecast as of November 30, 2010.

Driver: Low Interest Rates



Note: 10 yr T-Bill rate as of mid-Nov 2010, forecasts based on futures market, and implied forward rates, mid-Nov.
Source: Federal Reserve Board and FCS Annual Information Statements

This National Level Indicator does Not Show Evidence of a Recent Bubble



Source: FCA/ORP chart derived from USDA and Federal Reserve System data.

Past Run-ups in Farmland Occurred Under Different Conditions

Factor	1970's	2000's
Inflation	High inflation provided incentive to buy real assets on expectations of price increases.	Low inflation, but longer term concerns give incentive to hold real assets as a hedge against future inflation.
Global Commodity Demand	Russia and East Block countries enter grain markets - grain exports grew to 40% of production to unpredictable destinations.	Strong global growth, especially emerging markets. Dollar weakens. Dependence on exports fell to 20%.
Domestic Commodity Demand	Grains experience slow growth. Biofuels industry fails to develop.	Biofuels industry rapidly grows and consumes large portion of domestic corn crop by decade end.
Farm Policies	Supply management based commodity programs. Few risk management tools.	Counter cyclic and Direct Payment Programs. Wide array of subsidized production and price risk management tools.
Structure of Agriculture	Smaller farmers and more diversified production enterprises.	Larger, more sophisticated businesses and vertically integrated/industrialized.
Debt Leverage	Near 50 year peak, set-up for problems when rates rose and incomes declined.	Near 50 year lows.
Loan Underwriting	New System 85% L/AV limit, loans more focused on collateral value and appreciation.	More focus on repayment capacity.
Interest Rates	Negative real rates in 4 out of 10 years, provides strong incentive to leverage. Prevalence of variable rate financing leaves borrowers' exposed to rapidly rise in rates.	Real rates averaged 2.3%. Rates trending down to post WWII lows. More fixed-rate financing options are available.
Debt Pricing	System rates based on average costs, which underpriced credit & encouraged leveraging.	System rates based on marginal funding costs.

Observations On Current Farm Real Estate Market

- **Most land is sold to farmers** - desire to expand given prospect of attractive returns
- **High Non-farm investor interest** - farmland returns not correlated with stocks or bonds and far less volatile, diverse buyers
- **Thin markets** - owners in no rush to sell in rising market with strong income and few alternative investment options
- **Demand for quality land is strong** - recreational land markets weak, transitional land market gone

Future Land Prices – Drivers of Change

Drivers to watch	What potential risks could cause land prices to decline?
Farm Incomes	Volatile crop prices shift from upwardly volatile to downwardly so
Interest Rates	Modestly rising rates that turn sharply upward
Economy	Slowing growth in emerging markets, or U.S. growth stalls and deflation takes hold
Non-Farm Investors	Cost of holding farmland increases as alternative investments become more attractive
Energy Prices	Slower global growth causes fall in energy prices leading to similar impact on corn prices
Farm Policy	Farm programs focus more on risk management (insurance) tools, less on direct payments
Bio Policy	Ethanol subsidies are reduced, lowering corn demand
Tax Policy	Capital gains tax and/or estate tax rise
Credit Availability	Lenders loosen standards on farm land purchases, leading to excessive leveraging

Concluding Observations

- While prices have risen sharply, a National bubble in land prices was not apparent going into 2010.
- Land prices in transition areas could continue to decline and facility liquidations, such as dairy or hogs, could depress land prices in surrounding areas.
- Rising interest rates will negatively affect farmland prices, possibly offset by strong commodity prices.
- Land prices are likely going higher in 2011. The Agency's guidance and examination of collateral risk management practices will be timely.

FCA Guidance on Collateral Risk Management

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FCA Collateral Risk Management Guidance

- FCA's collateral risk guidance history
  - FCA response to the 1980s crisis – established our collateral evaluation regulations: Section 614 (September 1994)
  - Capitalizing Collateral Risk (March 2005 IM)
  - Significant Asset Growth and Its Implications (February 2007 IM)

FCA Collateral Risk Management Guidance

- More recent FCA guidance includes:
  - Asset Growth, Market Volatility, and Best Practices for Fast Growing Institutions (May 2008 IM)
  - FCA Bookletter – BL #58 in May 2009
  - Guidance for Evaluating the Safety and Soundness of Real Estate Lending (December 2009 Exam Bulletin)
  - FCA's Stress Testing Expectations (March 2010 IM)

FCA Collateral Risk Management Guidance

- Collateral Risk Management in FCS Institutions (June 2010 IM)
  - Encouraged improvement of collateral risk management practices
  - Defined real estate collateral risk
  - Urged institutions to stress test impact of a rising interest rate scenario
  - Identified examination expectations for managing collateral risk

FCA Collateral Risk Management Guidance

- National Oversight Plan for FY2010 and FY2011
  - Collateral Risk Management
    - ✓Points to heightened collateral risk in several stress sectors and regions
    - ✓Need for collateral risk studies
    - ✓Monitoring and assessing collateral risk
    - ✓Adjustments made to better manage collateral risk
    - ✓Influence on loan underwriting and stress testing

Future Analyses and Monitoring

- Evaluate farmland price changes
- Continue to analyze potential impact of changes in collateral values on the FCS
- Examination activities to continue focus on collateral risk management
- More collaboration with other financial regulators
- Improve quality of data