Farm Credit Administration

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Informational Memorandum

June 30, 2009

To: Chairman, Board of Directors
All Farm Credit System Institutions

From: Thomas G. McKenzie, Director and Chief Examiner
Office of Examination

Thomas G. McKenzie

Subject: Allowance for Loan Losses

In an Informational Memorandum dated November 14, 2008, (Link to Informational Memorandum on FCA's National Oversight Program) I alerted you of the Farm Credit Administration's (FCA) focus on the Allowance for Loan Losses (ALL) during upcoming examination activities. This informational memorandum provides you with FCA's recently revised Examination Manual Section for evaluation of the ALL (Examination Manual Section 335. Please distribute copies and discuss its contents with your board and management team to ensure your institution's policies, procedures, and ALL methodology are up-to-date and appropriately reflect consideration of the current economic environment, conditions, trends, and risks in your portfolio. We are concerned that past historical loss factors used by many institutions to determine ALL amounts may need to be supplemented to consider the realities of today's economic environment and accurately reflect embedded losses in loan and lease portfolios.

FCA's revised examination guidance reinforces the need for management to use prudent judgment supported by a thorough and well documented analysis of risks facing your institution when determining the appropriate level of ALL. As risk increases, boards of directors (boards) and management should fully understand, document, and conservatively apply judgments in establishing the ALL. The ALL reflects management's best judgment of losses embedded in the loan portfolio. Management judgment therefore is viewed as one of the most important areas requiring board oversight in ensuring the institution's condition is accurately reported to shareholders. Because of the importance of the management and board roles in this area on the confidence of shareholders, investors, and the public's confidence at both the institution and Systemwide level, I would like to reinforce to you the approach I have directed FCA examiners to apply when evaluating the ALL.

Foremost, examiners will look for a well documented analysis of the loss exposure to your institution. This analysis must be thorough with adequate details to provide support for the board and management's comprehensive understanding of the risk in individual loans and the risks emanating from the industries financed and the general economy. As general economic and industry conditions have weakened, the need to fully consider all risk factors have increased. In addition, the level of uncertainty associated with the ALL risk factors can be difficult to assess. Consequently, examiners will expect management judgment used in assessing ALL risk factors to be tempered with conservatism. Within the range of probable loss exposure allowed by Generally Acceptable Accounting Practices (GAAP)[1], boards and management should take the more conservative position in today's uncertain environment.

FCA's expectation for conservatism in management judgment on the ALL is consistent with the position taken by other regulators. For example, in his recent remarks to the Institute of International Bankers, Comptroller of the Currency John Dugan specifically provided his views on the current accounting standard for loan loss accounting (i.e., the incurred loss model), and the "…need to do a better job of telling banks and their auditors about the degree to which banks are permitted to use non-historical, forward-looking judgmental factors to justify provisions to the loan loss reserve." (Link to Comptroller Dugan's Speech) I encourage you to read Mr. Dugan's remarks and consider them as you review and update your ALL policies and methodology.

In accordance with current accounting standards, an institution can provide for a loan loss reserve if a loss is probable and it can be reasonably estimated. The recent prolonged period of good economic conditions experienced by System institutions—and by the global economy in general—may have made it difficult for management and institution boards of directors to justify significant provisions to the allowance for loan loss reserve. However, with the recent economic downturn, the speed with which it developed, the adverse economic conditions in many industry sectors and regions of the country, and the now-global nature of the recession, management and institution boards should monitor and respond to these changing conditions as well as look for opportunities to improve long term operational procedures (including ALL procedures) in light of the lessons learned by commercial and community banking sectors in the current environment.

In monitoring the adequacy of the allowance for loan losses, management and institution boards may need to consider the unique and varied characteristics of institution portfolios—such as, agricultural commodity and geographic concentrations, concentrations related to the terms of loan products, trends in loan-to-value ratios and the effects of decreases in collateral values, concentrations in repayment capacity from non-farm incomes, and the effects of weather-related or environmental conditions, just to mention a few.

Another very important factor affecting ALL decisions is the need for consistency in reporting System-wide financial results to investors and the public. With the rapid increase in FCS shared assets, it has become increasingly important for institutions to be consistent in the identification and reporting of risk. FCA has had a long-standing expectation for specific risk measures of loans to the same borrower to be reported consistently among institutions sharing in those loans. Our expectations apply to loan classifications, accounting and performance classifications, specific allowances, and charge-offs. To ensure consistency, we expect close coordination among institutions on shared loans. Typically, the lead lender has the most complete information and is expected to communicate changes in classification, allowance and charge-off. When examiners review risk in shared loans, they will typically communicate with the lead lender.

In summary, institutions must establish an allowance for loan losses consistent with GAAP, and to do that prudently, boards and management need to fully consider all the risks in an

[1] FCA regulations § 621.3 and § 621.5 require FCS institutions to comply with GAAP, including the determination of the ALL, for reporting purposes to shareholders, investors, and the FCA.

institution's portfolio, including changed economic expectations and current trends. Historical losses are not a sufficient basis alone for determining the adequacy of the ALL without considering the current risk in the industries served, trends in your portfolio, and the economy on the whole. Boards and management are strongly encouraged to use prudent judgment in their evaluation of all risks to establish a conservative ALL. However, the application of such forward-looking judgment to enhance the ALL process requires equally enhanced documentation and disclosures.

Finally, with the increases in shared assets within the System and the responsibility to report financial results at a Systemwide level, we expect institutions to communicate effectively and apply a consistent approach to risk classification, the ALL and charge-offs. As stated in my November 14, 2008 Informational Memorandum, examiners will be closely reviewing the ALL methodology and the adequacy of the ALL during upcoming examinations. The level of board and management's attention to this important area can affect our confidence in the overall management of your institution.

If you have any questions about this information, please discuss them with your examiner in charge or Dave Stephens, Director, Examination Policy Division, at (703) 883-4412.

Copy to: Chief Executive Officer
All FCS Institutions