Examination Bulletin: FCA 2006-2
Subject: Lending Programs for Farmers' Other Credit Needs

Date Published: 10/2006

PURPOSE

This bulletin provides Farm Credit Administration (FCA) examiners guidance for evaluating programs that Farm Credit System (System) institutions use in meeting the other (i.e., nonagricultural) credit needs of farmers, ranchers, and producers or harvesters of aquatic products (farmers). This bulletin clarifies "other credit needs financing" available to eligible borrowers as authorized by sections 1.11(a)(1) and 2.4(a)(1) of the Farm Credit Act of 1971, as amended, and defined by FCA regulation 613.3000.

INTRODUCTION

FCA Regulation 613.3005 envisions financing of farmers' agricultural needs and provides general parameters for financing their other credit needs. The regulation provides System institutions significant latitude to implement these parameters within the lending objectives established in the rule. In order to comply with the general parameters in § 613.3005, examiners should expect institution boards of directors to establish clear policy direction that outlines the institution's program for implementing the regulation and meeting the credit needs of farmers, including their other credit needs. The program should also establish appropriate underwriting standards to comply with FCA Regulation 614.4150. There are a number of safety and soundness and regulatory issues that examiners need to consider when evaluating institution programs for meeting farmers' other credit needs. In addition to the discussion of these issues, Attachment 1 provides a list of examples of financing for nonagricultural purposes and whether they would likely be in compliance with § 613.3005. A workpaper listing criteria to consider in examining a System institution's other credit needs financing program is provided at the end of this document.

EXAMINATION GUIDANCE

<u>Board Policy and Internal Control Considerations</u>

Financing for other credit needs should be provided in accordance with prudent lending practices and within board established parameters. As such, programs developed for other credit needs financing should have reasonable limitations and safety and soundness controls. An examiner's evaluation of other credit needs financing should start with an assessment of the institution's internal controls. Examiners should expect to see:

- A board-approved policy that communicates the board's expectations regarding the purpose, objectives, and scope of the program for financing farmers' other credit needs.
- Operating parameters and portfolio limits for non-agricultural purpose loans.
- Guidance on authorities delegated to management and retained by the board for approval or action, including a process for addressing exceptions.
- Sufficient lending expertise to provide other credit needs financing in a safe and sound manner.

- Appropriate underwriting standards that address the different set of credit and collateral risks associated with loans for nonagricultural purposes.
- Guidance clarifying that lending should be on a more conservative basis as the purpose moves away from agriculture and that credit can not be extended for purposes of investment in agricultural assets for speculative appreciation.
- Training provided to lending, legal, and audit/review staff on the institution's program for other credit needs.
- Internal audit/review coverage of other credit needs financing programs.
- Periodic reporting to the board and management on loan portfolio composition, performance, and exceptions to other credit needs policy requirements.

A review of these factors, as well as the results of internal audit/review activities, will help the examiner determine the level of individual loan testing needed to determine compliance with program and regulatory requirements.

Regulatory Considerations

The institution's policy and program for other credit needs financing should also address a number of regulatory issues. In evaluating other credit needs programs, examiners should expect to see guidance that addresses the degree of agricultural involvement, loan purpose, and the amount of financing that can be provided, and defines key terms, as outlined below. Examiners should also expect the institution to document the basis for other credit needs lending in the loan file, including the basis for the borrower's designation as a full or less than full-time farmer, support for the loan purpose, and the determination of the amount of other credit needs financed.

1. Agricultural Involvement

Full-Time Farmers

If an eligible borrower is a full-time farmer, then under § 613.3005, the farmer can receive full credit, which includes full credit for the farmer's other credit needs. Therefore, a System institution's program should define what constitutes a "full-time" farmer (i.e., one whose "primary" business and vocation is farming, ranching, or producing or harvesting aquatic products). The program may reasonably define full-time farmer in more than one way by using a combination of factors such as gross farm income, value of agricultural assets, size of the agricultural enterprise, time spent farming, educational background, training, experience, and business plans and trends. For example, the USDA's Agricultural Resource Management Survey (ARMS) counts full-time farmers as those operators who report farming as their major occupation. Whatever method is chosen to define "full-time" farmers, it is critical that System institutions base the definition on reasonably objective criteria, tailored to the relevant conditions for farming in the institution's chartered territory.

Less Than Full-Time Farmers

Under § 613.3005, System institutions are to provide more restricted credit for the other credit needs of less than full-time farmers. Therefore, the programs should define what constitutes a less than full-time farmer and/or part-time farmer in the institution's territory – including the minimum level of farm activity necessary to be considered a farmer. Many of the same factors used by the institution to define full-time farmers could be used to define "less than full-time" farmers. For example, the USDA's ARMS defines "farmer" as any individual that produces more than $1,000 of gross farm income. The program should also provide a definition of a borrower whose business is “essentially other than farming,” since agricultural needs only can be financed for those borrowers.

Assets

The program should provide for an evaluation of the totality of the borrower’s assets (owned or controlled) to assist in determining the degree of agricultural involvement, loan purpose, and amount of financing as discussed in item 3 below. However, from a regulatory perspective, this evaluation of the borrower’s assets is not necessary as a basis for decisions regarding security requirements for the loan. Decisions regarding these requirements need to be made apart from eligibility and scope of financing decisions. Security requirements for an “other credit needs” loan should be based on the borrower’s creditworthiness and loan terms in accordance with Part 614 of FCA regulations (See § 614.4200 and FCA’s Informational Memorandum on Security for Long Term Loans, dated May 11, 2006).

2. Purpose

Agricultural Needs

The program should define what the institution considers to be “agricultural needs” financing. All agricultural needs can be met for full-time and less than full-time farmers, including borrowers who are essentially other than farmers.

Family Needs

The program should define what the institution considers to be “family needs” financing (which is not defined in FCA regulations, but could include such things as housing, home improvements, transportation needs, medical and education expenses) and include parameters, such as reasonable limits on housing values, for those family needs. Under § 613.3005, System lenders can provide full credit for family needs financing to both full-time and less than full-time farmers. Hence, although it is a subset of "other credit needs" financing, financing for family needs is not restricted for the part-time farmer carrying on a valid agricultural operation.

Nonagricultural Activities

The program should outline the type of nonagricultural purposes that will be financed as “other credit needs.” Financing for nonagricultural purposes could include investments in nonagricultural businesses and other credit needs that facilitate the farmer’s agricultural activities and ability to remain in agriculture. Examiners should be mindful that providing for an adequate and flexible flow of money into rural areas is a part of the System's overall public purpose mission. Therefore, other credit needs loans that provide funding in rural areas may be more consistent with § 613.3005. The program should identify the circumstances under which loans will be allowed to finance businesses outside of "rural" areas. “Rural” can be defined by each System institution based on reasonably objective criteria (See FCA Informational Memorandum on Security for Long Term Loans, dated May 11, 2006).

3. Amount of Financing

The program should establish a clear method for determining the amount of other credit needs financing that can be extended. Such a method should be linked to the borrower’s involvement in agriculture and loan purpose, as discussed above. This could be accomplished in a number of ways. For example, lending up to the value of agricultural assets for nonagricultural purposes is one way to limit financing to less than full-time farmers. If institutions use an asset-based approach, agricultural assets need to be reasonably defined and consistently valued, and the assets must remain agricultural after the nonagricultural extension of credit. Placing a cap on the value of agricultural land that is being influenced by nonagricultural factors (land that may have a much higher market value than its value for agricultural purposes) is one way to ensure agricultural assets remain reasonably valued. Other considerations for determining the amount of other credit needs financing may include multiples of agricultural production, income, or other measures commensurate with the degree of agricultural involvement.

To be within the bounds of § 613.3005, it is not necessary that the program require a borrower's agricultural loans to exceed the amount of other credit needs loans nor is it necessary for a farmer to have an existing relationship with the institution (i.e., outstanding agricultural loans) to receive other credit needs financing. An important factor in evaluating what financing needs can be met for less than full-time farmers is where the borrower falls on the § 613.3005 continuum from a full-time farmer to essentially other than a farmer. Examiners should ensure that an institution has considered the totality of the circumstances – the combination of person, property, and purpose – to determine the amount of financing to a less than full-time farmer. The "totality of the circumstances" could include such factors as the farmer's history, current involvement, and future plans regarding his farming and non-farming activities. If such information, for example, shows a trend toward a move out of agriculture, an institution would have difficulty justifying the total credit as being "primarily an agricultural loan" if the other credit needs financing exceeds the agricultural financing. However, if the circumstances show that the other credit needs financing allows the farmer either to remain in farming or to transition more into agriculture, a System lender would have a strong basis in justifying the total credit as resulting in "primarily an agricultural loan." In sum, the determination of what constitutes "primarily an agricultural loan" is to be decided on a case-by-case basis, taking into consideration how the loan proceeds will benefit the borrower’s agricultural activities.

Financing farmers’ other credit needs in accordance with the law, regulations, and sound business practices is beneficial to enhance or support the economic vibrancy of agriculture and rural communities. The principle objectives of a board-approved program should be to provide financing necessary to ensure full-time farmers receive sound and constructive credit to support their full needs and that part-time farmers are provided appropriate financing to allow them to remain in agriculture and a rural community. In addition, the programs should be targeted toward ensuring the flow of funds into rural areas and tailored to the conditions in the institution’s lending territory. If an institution develops an other credit needs lending program consistent with the guidance in this document, examiners should consider the collective loans made to a borrower under the program to be "primarily agricultural loans" and consistent with § 613.3005.

Date

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Attachment 1

Examples

The following examples highlight the characteristics of loans that may be found during review of an "other credit needs" lending program and whether they would likely be consistent with FCA Regulation 613.3005. These examples are designed to be illustrative only and reflect how a program that allows lending for nonagricultural purposes up to the value of agricultural assets could be applied. Other programs could be structured differently. To ensure regulatory compliance, examiners should consider the totality of circumstances (such as the extent of the borrower's agricultural activities and the parameters of the System institution's program for nonagricultural credit) when evaluating an actual loan for nonagricultural needs. In reviewing any program, examiners should use reasonable judgment in evaluating the level of nonagricultural lending that is appropriate. For example:

1. **Facts:** A part-time farmer with $30,000 of gross farm income, $200,000 of agricultural real estate, $100,000 of agricultural loans requests $75,000 to finance the purchase of a restaurant in a town of 5,000 people. He does not plan to expand his farming operation but plans to continue to farm. **Analysis:** The amount of financing is less than the value of agricultural assets, and the purpose of the loan contributes to the part-time farmer's ability to remain in agriculture and enhances the flow of funds into a rural area, even though the borrower does not expect to become more involved in farming. **Result:** This loan is likely consistent with § 613.3005.

2. **Facts:** Same as Number 1, but only $50,000 of agricultural loans. **Analysis:** Although the nonagricultural portion of the loans is larger than the agricultural portion, the amount of financing is significantly less than the total value of the borrower's agricultural assets, and the purpose of the loan improves the borrower's ability to remain involved in farming and enhances the flow of funds into a rural area. **Result:** This loan is likely consistent with § 613.3005.

3. **Facts:** A part-time farmer with $1,000 of gross farm income from cattle, $100,000 of agricultural assets, and $50,000 of agricultural loans requests $100,000 to finance an apartment building in a town of 10,000 people. She has documented plans to expand her farming operation and generate additional farm income in future years. **Analysis:** The borrower's primary vocation is currently something other than farming but is moving toward more active farm involvement, and the purpose of the loan contributes to her ability to remain on the farm. **Result:** This loan is likely consistent with § 613.3005.

4. **Facts:** A borrower owns agricultural property that is valued at $2.0 million on the outer fringe of a large metropolitan area and would like to borrow $1.0 million for an apartment building in the city. The property is currently in the Conservation Reserve Program and the borrower plans to maintain some of the land in the program and sell the rest for development, using the proceeds to repay the loan. While actively farming in the past, the borrower now plans to move out of farming and the remaining property would not be maintained as an agricultural asset. **Analysis:** The nonagricultural business does not improve the borrower's ability to remain in farming nor does it enhance the flow of funds into a rural area. Also, the borrower, whose business is essentially other than farming, could receive credit only for agricultural purposes. **Result:** This loan would likely *not* be consistent with § 613.3005.

5. **Facts:** A borrower with gross farm income of $300,000 and revenue from a farm equipment dealership of $500,000 requests financing of $2.0 million to start a manufacturing business in a community of 30,000 people. Agricultural assets total $1.5 million, and nonagricultural assets total $2.5 million. Although the borrower's gross farm income is less than the revenue from the farm equipment dealership, he spends the majority of his time operating his farm and views it as his primary occupation. **Analysis:** This borrower could likely qualify as a full-time farmer and, as such, would be able to obtain full financing for both agricultural and nonagricultural needs. **Result:** This loan would likely be consistent with § 613.3005.

6. **Facts:** An investor who lives in Chicago and owns $1.0 million of agricultural real estate requests financing for $500,000 to purchase an auto supply store in the Chicago metropolitan area. Although the borrower derives farm income from leasing the agricultural property, he plans to sell off most of his agricultural real estate to open a chain of auto supply stores. **Analysis:** The investor is essentially other than a farmer, and the purpose of the loan would not result in funds flowing into a rural area. **Result:** This loan would likely *not* be consistent with § 613.3005.

7. **Facts:** A part-time farmer with agricultural assets (primarily land) valued at $750,000, gross farm income of $5,000 from hay sales, and no existing financing relationship with a Farm Credit System institution requests a loan for $750,000 to expand his commercial business in a rural community with a population of 15,000 people. **Analysis:** The amount of financing is not more than the value of agricultural assets, and the purpose of the loan contributes to the part-time farmer's ability to remain in agriculture and a rural area. **Result:** This loan would likely be consistent with § 613.3005.