BL-062
Evaluating Strategies and Risks for Loan Pricing and Structure

May 13, 2010

To: Chairman, Board of Directors
Chief Executive Officer
Chairman, Asset/Liability Management Committee
All Farm Credit System Institutions

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Evaluating Strategies and Risks for Loan Pricing and Structure

This bookletter provides guidance for the pricing and structure of loans to ensure appropriate earnings performance. Earnings performance is critical to the viability of a Farm Credit System (System) institution as it is the first line of defense against loan losses and the erosion of capital. Accordingly, investors in System debt and the rating agencies view System earnings and profitability as a major component of the System's financial stability. Conversely, declines in earnings performance can adversely impact the System's ratings and/or increase the cost of funding.

Background

The System generates the majority of its earnings from loans. Therefore, strategies for loans, including loan pricing, structure, funding, liquidity, and risk management, play a fundamental role in the earnings performance of a System institution. Appropriate loan pricing and structure decisions are particularly critical during volatile economic times, as recently experienced and likely to occur again in the future. Sufficient earnings help maintain the System's strong bond ratings and its reputation with investors, enable it to serve its mission, and ensure member owners benefit from their System cooperative.

Section 1.1(c) of the Farm Credit Act of 1971, as amended (Act), requires System institutions to provide equitable and competitive interest rates–taking into consideration a borrower's creditworthiness, access to alternative sources of credit, cost of funds, cost of servicing, and the need to retain earnings to protect borrowers' stock. Further, the Act states that in no case is any borrower to be charged a rate of interest that is below competitive market rates for similar loans made by private lenders to borrowers of equivalent creditworthiness and access to alternative credit. Therefore, properly pricing for risk in individual loans is critical to determining whether an institution is pricing loans consistent with rates available in the marketplace for loans that present similar risk characteristics.

Guidance

This bookletter communicates critical factors each System institution should consider when developing loan pricing and structure strategies. These strategic responsibilities reside with the board, but are typically administered by the institution’s asset/liability management committee (ALCO). As discussed in FCA bookletter BL-012, dated January 15, 1991, all System institutions should have an asset/liability function administered by an ALCO as a critical component of its management system.

Due to the significant impact of loan pricing and structure on System institutions’ earnings capacity, and to ensure consistency with the institutions’ business plan goals in the current operating environment, System institutions’ boards should continue to evaluate their direction and control over pricing and structure decisions. System institutions should manage loan pricing and structure using strategies that are well-developed, documented, and available for board and regulatory review. Boards of directors and senior management should review the institution’s portfolio strategy periodically and should increase the frequency of review if the operating environment or portfolio mix warrants additional attention.

FCA regulations require System institutions to adopt written standards for prudent lending and written policies and procedures for prudent credit and loan pricing and structure practices. Specifically, when establishing and reviewing loan pricing and structure policies, procedures, standards, and practices, the FCA expects each System institution to:

1. Ensure loan pricing and structure decisions are consistent with the board’s portfolio strategy and business plan objectives.
2. Incorporate appropriate risk based premiums into differential loan pricing programs.
3. Ensure the loan product mix provides sufficient flexibility to adjust rates/returns.
4. Evaluate how loan pricing and structure practices are affecting loan portfolio salability/liquidity.
5. Ensure pricing on all loan products/structures appropriately considers credit risk over the term of the loan, including the uncertainty of credit conditions in future periods.
6. Evaluate whether pricing practices provide sufficient margins for patronage and/or financial uncertainties of the institution.
7. Ensure loan pricing and structure practices meet statutory and regulatory objectives.

In addressing these areas, your institution’s ALCO should, at a minimum, consider and address the questions discussed in the attachment. FCA examiners will use this guidance to aid in the evaluation and discussion of loan pricing and structure practices with System ALCOs, audit committees, boards, and management teams.

If you have questions in regard to this guidance, please contact Barry Mardock, Associate Director, Office of Regulatory Policy, at (703) 883-4456, or at mardockb@fca.gov, or Tim Nerdahl, Policy Analyst, Office of Examination, at (952) 854-7151, ext. 5035, or at nerdahlt@fca.gov.

Attachment

Attachment

1. How are loan pricing and structure used to achieve portfolio strategies and business plan objectives?

Each System institution should establish business plan goals and related portfolio strategies considering the board's risk appetite, its lending environment and the need to meet the System's long-term mission to serve agriculture. Loan pricing and structure are the critical tools for achieving these goals and strategies. A portfolio strategy assesses the current composition of an institution's portfolio, evaluates the loan products that are currently offered, and then provides the board and management's vision of what the portfolio composition should look like in the future. For example, a System institution may see opportunities to diversify the portfolio through syndications and loan participations or changing the duration of the portfolio from long-term loans to more short-term loans or vice versa. The FCA considers the review and assessment by a System institution of its portfolio strategy to be a prudent business practice and an integral part of its business and capital planning process. Conversely, operating without a portfolio strategy could result in excessive portfolio concentrations and insufficient earnings performance levels in future periods.

A portfolio strategy developed as part of the business planning process should cause a System institution's board and management to ask critical questions regarding the institution's expertise and capital adequacy. For example, System institutions involved, or planning to become more involved, in capital markets/participation activity should proceed in a thoughtful manner after fully considering the following questions: 1) How well do we understand loan pricing and structure in this marketplace? 2) Do we have a solid strategy and do we truly have the expertise and experience necessary to engage in this business activity and conduct our own due diligence in a prudent and sound manner? 3) Are the terms and returns available in the marketplace for these loans consistent with our risk management objectives? 4) How much capital will be needed to support the risk associated with moving into these new products or types of loans? 5) What type of risk-adjusted return do we need to adequately compensate our shareholders for the risk taken? By asking these types of questions, management and the board can provide a clear assessment of what it will take to enter different markets and whether this business will contribute to the institution's overall success.

2. Do your pricing programs provide for sufficient risk differential?

System institutions should be compensated for the risk they are taking. Different loans present different risks, depending on variables including loan type, purposes, terms, collateral risk, amount, quality, and financial stability of the borrower. As a result, higher interest rates should be established for loans that expose an institution to more risk. A borrower whose loan is appropriately risk rated a 4 or 5 should generally pay a lower rate of interest than a similarly situated borrower whose loan is risk rated an 8 or 9 for the same product (if financed at the same time). Likewise, borrowers whose loans pose higher loss expectation in the event of default should also pay a premium compared to borrowers whose loans pose a low loss expectation in the event of default.

Differential or tier-based pricing programs are designed to ensure interest rates charged to borrowers reflect the inherent risk in specific loans or loan types. As provided for in FCA regulation § 614.4160, differential loan pricing allows System institutions to reflect the variances in costs associated with various loan products while ensuring that equitable rate treatments are achieved within categories of borrowers. Interest rates may be differentiated by risk factors (e.g., classification/risk rating, loss given default rating, or performance status), loan characteristics (e.g., size, enterprise, servicing costs, collateral risk, or credit factors), loan terms, geographic area, or a combination of factors. Often, stress testing helps to differentiate the underlying risk exposure of a loan under various economic scenarios, which can serve to ensure an institution is appropriately pricing a loan consistent with risk it represents.

The establishment of interest rates requires analysis of risk in the loan portfolio to determine whether spreads remain adequate given the level of risk in the particular loan or group of loans. Controls should be in place to ensure that loans are assigned differential rates according to established procedures and are reviewed to ensure proper assignment and recording. While pricing exceptions can be granted for competitive reasons, System institutions should monitor the rate of exceptions to ensure the integrity of the pricing program and achievement of earnings objectives. Loans should be reviewed periodically, at renewal, or as repricing opportunities arise, to assess performance and adherence to program criteria. Failure to make necessary adjustments can result in insufficient returns relative to the changes in risk exposure.

System institutions should establish a means whereby differential loan pricing practices and risk-adjusted returns are monitored on an ongoing basis. This allows a System institution to make adjustments if the return on a specific loan product is inadequate in relation to the institution's business plan goals and/or risk assumed. Boards should also monitor this type of information to remain informed about the institution's loan pricing practices.

Risk-adjusted pricing models should be used in the pricing process. These models can vary from relatively simplistic to more sophisticated models, such as economic capital and risk-adjusted return on capital models. At a minimum, these models should consider the cost of funding, option risks that are not eliminated through funds transfer pricing, allocated operating costs, expected and unexpected loan losses, and profit objectives. These models could also consider other factors, such as loan structure and the effects of diversification or concentration. Any pricing model is highly dependent upon underlying assumptions and historical information. As a result, institutions should have processes for accumulating this information and validating assumptions. The complexity of validation processes should vary in accordance with the complexity of the pricing model.

3. Do your loan pricing and structure practices provide sufficient flexibility to maintain stable earnings and protect capital?

System institutions, from time to time, will need to adjust their interest rates to generate sufficient earnings to protect capital. Interest rates and spreads that appear sufficient during strong economic times may prove to be insufficient during economic downturns and/or times when funding markets are volatile or access is otherwise restricted. System institutions should have strategies in place to evaluate whether their loan pricing practices will continue to meet earnings objectives during periods when the funding environment becomes more volatile, market interest rates are changing rapidly, and credit risk is increasing. An institution's pricing program should ensure that loan spreads are adequate to cover risk (including future allowance needs) and funding costs, and provide a sufficient return to capital throughout the term of the loan, including during a volatile operating environment. Use of differential pricing programs, economic capital models, market studies, and other risk analysis tools can be useful for ensuring appropriate pricing relative to risk in individual loans. System institutions should use such tools to evaluate whether their loan pricing and structure practices provide sufficient flexibility to adjust spreads and interest rates charged to borrowers. It is critical that System institutions make the tough decision to increase and maintain spreads when adverse conditions are expected or become evident in the institution's operating environment.

Many System institutions offer administered-rate loans in part because these loan products provide flexibility to increase rates or increase spreads when needed. Contractually, administered rates can be changed periodically regardless of changes in market rates. In theory, administered-rate loans provide the flexibility to increase spreads at any given time with proper notification. However, in practice, administered-rates might not be changed in a manner fully responsive to changes in market rates or risk conditions in the environment. Administered-rate changes can be unresponsive to market rate changes if institution boards and management are hesitant to change rates given concerns over membership reaction. Failure to adjust administered-rate loans in concert with market rates may result in unintended consequences for a System institution, such as reduced spreads and earnings performance. Accordingly, System institutions should have significant discipline and internal controls over administered rates to ensure needed rate changes are made in a timely and appropriate manner.

If priced and funded properly, a loan portfolio that contains a large volume of fixed-rate and/or indexed-rate loans should, over time, produce a relatively stable stream of earnings. However, if these loans are aggressively priced with thin spreads, they may produce, over time, a loan portfolio with insufficient margins to generate the earnings necessary to provide for loan losses and protect capital. System institutions with large concentrations in fixed-rate and indexed-rate loans can only adjust spreads by increasing rates on new loans and existing administered-rate loans, taking these institutions much longer to increase their overall portfolio profitability. In addition, System associations' transfer pricing programs with their funding banks may allow the bank to change spreads charged to its associations at any time. Consequently, spreads may compress on existing loans in the portfolio. Accordingly, an association's portfolio mix and pricing strategies should provide sufficient flexibility to ensure that the loan portfolio continues to provide sufficient returns under varying conditions.

4. How do your loan pricing and structure practices impact the liquidity of your loan portfolio?

To fully understand the impact of its loan pricing and structure decisions, System institutions should consider how their loan products would sell in the financial marketplace. While System institutions generally hold loans they originate, and the secondary market for agricultural loans remains a limited source of liquidity, institutions are encouraged to evaluate the market value of their loans. We recognize there are unique features to System loans that could impact their value and salability; however, we believe it is important for System institutions to determine the market value of their loan portfolios as a tool to measure how liquidity and capital strength are impacted by loan pricing and structure decisions. The various structures, lack of standardized market terms and covenants, and optionalities of the products offered can greatly impact a loan's salability and value in the marketplace. Loans that are structured in a way that could reduce salability should not have liquidity impacted further by insufficient pricing.

One way System institutions could evaluate portfolio salability is to periodically complete an analysis of the liquidity and market value of their loan portfolio. This analysis could include data supporting the marketability of the loan portfolio and expected market price that could be achieved. This analysis would keep management teams and boards informed on decisions resulting from their loan offerings and how these decisions have impacted earnings and liquidity of their institution. This information would then allow management to make adjustments needed to meet earnings and liquidity objectives.

5. When evaluating the risks associated with long-term loans, how do you ensure that they are appropriately priced and provide adequate compensation for the risks assumed?

Long-term loans pose unique risks that System institutions need to fully consider in pricing decisions. System institutions that index or lock in borrower interest rates for long periods of time may be protecting the borrower from rising interest rates, but may be under-pricing for the uncertain credit risk in future periods. Consequently, System institutions should ensure that interest rate spreads on long-term fixed-rate loans are sufficient to compensate for the additional risk being assumed over the life of the loan.

Risk in long-term loans emanates from the uncertainty of future economic events. In addition, institutions often find it difficult to obtain current information on the borrower's financial condition and performance and are typically unable to adjust loan pricing based on changes in the borrower's risk profile. Without updated financial information it is difficult to identify deterioration in credits prior to a customer missing a payment. To address this risk, many institutions make loans with 15- or 20-year amortizations with balloon payments due in 5 to 7 years. The balloon maturity provides an opportunity to revisit the borrower's risk profile. Loan documents, at a minimum, should be designed to obtain updated financial information when needed. Accordingly, System institutions should ensure that proper controls and/or pricing for long-term fixed-rate loans mitigate and/or compensate the institution for assuming this risk.

6. How do your patronage practices enter into loan pricing and structure decisions?

System institutions with sufficient earnings may reflect those earnings in making patronage payments to their customers or in offering more advantageous loan terms to their customers. Charging customers a rate up front that supports plans to pay patronage later can help ensure that System institutions have an earnings buffer in the event provisions for loan losses, in excess of business planning projections, become necessary. This additional flexibility and buffer for an institution is also recognized by investors in System debt securities. Investors tend to focus on the System's pre-patronage return on assets and equity, recognizing that institutions can lessen or defer patronage payments based on the needs of the institution. Nevertheless, System institutions that have a history of paying patronage refunds and then stop or lessen payments can experience borrower discontent as members come to expect patronage refund checks. Accordingly, System institutions should ensure that member/borrowers are fully informed that as a cooperative, the capital needs of the institution may take priority over the patronage needs of the membership during periods of economic stress.

Some System institutions offer more advantageous loan terms to their customers to compensate for not paying patronage. However, charging lower rates and achieving lower spreads on loan products may not provide for the additional earnings necessary for financial uncertainty. Financial uncertainty would include unplanned provisions for loan losses, capital erosion, and other unforeseen expenditures. In these cases, compensating strengths should be in place to mitigate financial uncertainty. Compensating strengths could include higher capital levels, a low operating expense rate, or the use of conservative underwriting standards and lending limits. Consequently, pricing programs that do not take into consideration the potential for financial uncertainty or possess compensating strengths can be considered unsafe and unsound.

7. How do your loan pricing and loan structure practices help meet your institution's statutory and regulatory service objectives?

An institution's portfolio strategy must provide for an adequate and flexible flow of funds into rural areas and provide competitive credit for farmers and ranchers. Chosen strategies must also accommodate the furtherance of statutory and regulatory service objectives. For instance, FCA regulation § 614.4165 requires System institutions to establish programs to provide sound and constructive credit and services to young, beginning, and small (YBS) farmers, ranchers, and producers or harvesters of aquatic products. As further discussed in FCA bookletter BL–040 Revised, such programs could include applying more flexible interest rates or fees, customized loan underwriting standards, loan guarantee programs or other credit enhancement programs. In addition, FCA regulation § 614.4160 states in the adoption of differential interest rate programs, institutions may consider, among other things, the effect that such interest rate structures will have on the achievement of objectives relating to the special credit needs of YBS farmers.

A sound portfolio strategy provides System institutions with the foundation to ensure that sufficient earnings and capital are in place to fully implement the System’s statutory and regulatory service objectives. A critical component of that strategy is to have in place pricing and structure practices that ensure that credit is available, where and when it is needed most. Therefore, the critical factors discussed above must be considered in the context of the System’s overall mission to provide sound and dependable credit to agriculture and rural America.