INTERPRETIVE LETTER 08-03 (June 9, 2008)

Lending limit for loan to grain elevator when the loan is collateralized by a warehouse receipt is computed in accordance with Section 34(6). In addition the letter provides best practices for banks doing business with licensees under the Grain Code.

This is in response to your recent correspondence in which you asked the Department of Financial and Professional Regulation, Division of Banking ("Division") a number of questions regarding lending limits and their relation to the grain markets.

The statutory lending limits are set out in Section 32 of the Illinois Banking Act ("Act")[1]. Generally, loans outstanding at one time to a borrower may not exceed 25% of a bank's unimpaired capital and unimpaired surplus. In addition, the total liabilities of a person, for money borrowed or otherwise, cannot exceed 25% of the deposits of the bank and those total liabilities shall at no time exceed 50% of the amount of the unimpaired capital and unimpaired surplus of the bank. Sections 34 and 35[2] provide certain exceptions and exemptions to this general lending limit based on the type of collateral securing the loan.

One exception found in Section 34 deals with loans secured by documents of title covering readily marketable staples. Under Section 34(6), a state bank may make a loan on readily marketable staples in an amount not to exceed 50% of the bank's unimpaired capital and unimpaired surplus, provided that the amount above 20% of the bank's unimpaired capital and unimpaired surplus is and will remain secured by accompanying documents of title. As such, the limit on loans collateralized by grain warehouse receipts is 50% of the bank's unimpaired capital and unimpaired surplus, provided that an amount equal to at least 30% of the bank's unimpaired capital and unimpaired surplus is and will remain secured by a warehouse receipt.

In determining the lending limit for a loan that is cross collateralized with a variety of assets, including for example grain warehouse receipts, real estate, futures contracts, and accounts receivable, a bank will first determine its 25% lending limit under Section 32[3]. If the bank has grain warehouse receipts to secure the loan, it can go above the 20% limit up to 50% of the bank's unimpaired capital and unimpaired surplus to the extent that the loan is and will remain secured by the warehouse receipts. If bank does not have warehouse receipts to secure an amount up to 50% of bank's unimpaired capital and unimpaired surplus but does have other collateral that might qualify as an exception under Section 34, a similar analysis would have to be done recognizing that except in very limited circumstances, the total liabilities of a person cannot exceed 25% of the bank's deposits and 50% of the bank's unimpaired capital and unimpaired surplus.

For example, a bank has loans outstanding that comprise 30% of the bank's unimpaired capital and unimpaired surplus that are partially secured by warehouse receipts. In order for the bank to avoid a legal lending limit violation, the bank will need to have, at a minimum, sufficient warehouse receipts on hand to secure an amount equal to 10% of the bank's unimpaired capital and unimpaired surplus. Further, if a bank has loans outstanding that

[1] 205 ILCS 5/1 et seq.
[2] 205 ILCS 5/ 34 and 205 ILCS 5/35.
[3] 205 ILCS 5/32.

comprise 50% of the bank's unimpaired capital and unimpaired surplus that are partially secured by warehouse receipts, the bank will need to have, at a minimum, sufficient warehouse receipts on hand to secure an amount equal to 30% of the bank's unimpaired capital and unimpaired surplus and have no other lending relationships with the borrower that are not exempted from the legal lending limits to avoid a legal lending limit violation.

Your letter asked whether a bank that collateralizes borrowings with warehouse receipts is required to have an independent registrar maintain the receipts. There is no such requirement in the Act, the rules promulgated in accordance with the Act or any other issuance of the Division. Further, as to whether there are any rules or regulations regarding loaning money to a grain elevator and collateralizing those borrowings with futures contracts and with a contract to purchase grain from a farmer, i.e. hedged position, the Division has not promulgated regulations addressing this segment of a bank's lending activity. However, given the complexity and risks associated with grain inventory financing, the Division believes that from a safety and soundness perspective banks involved in these financing arrangements should:

1) be knowledgeable of ancillary laws and regulations that may mitigate a bank's loss exposure should there be a failure of an Illinois licensed grain dealer or warehouseman, as well as circumstances that may call into question a bank's contract equity collateral related to the financing of to arrive contracts; and

2) adhere to prudent safety and soundness guidelines for monitoring the performance of these lending relationships.

Grain Code and To Arrive Contracts

The Grain Code[4] ("Code") was enacted in 1996 in an effort to provide protection to grain producers in the event of a failure of an Illinois licensed grain dealer or warehouseman. Under the Code, certain entities, including Illinois licensed grain dealers and warehousemen as well as entities providing loans to licensees, pay assessments into the Illinois Grain Insurance Fund ("Fund"). Through the liquidation procedures of the Illinois Department of Agriculture ("Department") and the Fund, entities with valid claims will get some recovery in the event of a failure of an Illinois licensed grain dealer or warehouseman.

In order for a lender to avail itself of the protections of the Code, it would have to qualify as a claimant. Under Section 1-10[5] of the Code, a lender qualifies as a claimant if it possesses a warehouse receipt issued covering grain owned or stored by a failed licensed warehouseman or possesses other written evidence of a storage obligation, such as a scale ticket, a settlement sheet, or a ledger card, from a failed licensed warehouseman issued in favor of the lender. In addition, if a lender surrenders a warehouse receipt as part of a grain sale and is not paid in full within 21 days of the surrender, the lender would qualify as a claimant. If 22 days pass and payment is not received, there would be no coverage afforded the surrendered warehouse receipt. If written notice is provided to the Department within 21 days after the surrender, coverage is preserved.

In the event of the failure of a licensee under the Code, there are two sources of recovery for a claimant. The Code provides that the Department liquidate the grain assets, collateral, and

[4] 240 ILCS 40/1-1 et seq.
[5] 240 ILCS 40/1-10.

guarantees of the failed licensee. The Department may liquidate the equity assets that are not subject to a prior perfected lien. Proceeds of the liquidation are deposited into the Grain Indemnity Trust Account[6]. Valid claims filed by a warehouse claimant will be paid 100% of the amount determined by the Department out of the net proceeds of the liquidation. If proceeds from the liquidation are insufficient to cover all claims, warehouse claimants will be paid their pro rata share of the proceeds from the liquidation of grain assets and an amount, not to exceed $1,000,000 per claimant, out of the Fund[7].

Finally, the Division cautions banks about uncertainties with to arrive contract financing. Lenders should ensure that the contract is in writing, signed by the producer, and contains language, similar to that found in the model contracts developed by the National Grain and Feed Association, in order to put the lender in the best possible position to enforce or assign the contract, if necessary. The validity of the contract could be called into question if the license of the grain dealer is revoked[8]. At this point, the bank may no longer have a secured collateral position.

Safety and Soundness Considerations

The Division reminds banks that there are certain safety and soundness guidelines they should use when making loans secured by warehouse receipts. Grain dealers and warehousemen are required to issue receipts in numerical order. Receipts that are substantially out of sequence should be a red flag and lead to further investigation. Further, banks that have a significant lending relationship with a grain dealer or warehouseman in which the primary security is warehouse receipts should establish loan covenants that:

1) require the borrower to provide its daily position record at the time they provide the warehouse receipt as collateral. The bank should review the daily position record in an effort to reconcile the amount of grain available for pledge as well as to learn of other outstanding liens on the grain supply;

2) require the borrower to obtain an independent collateral audit on an annual basis; and

3) require licensees to provide the bank with a copy of Department Examinations and findings on a regular basis.

[6] 240 ILCS 40/20-15.
[7] 240 ILCS 40/25-10.
[8] 240 ILCS 40/15-40.