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March 27, 1996

To: The Chief Executive Officer

 All Farm Credit Institutions

From: William L. Robertson, Acting Director

 Office of Examination

Subject: Loan Participation Requirements

Several Farm Credit System (FCS or System) institutions have raised questions about the scope of their authorities to participate in loans and leases under various provisions of the Farm Credit Act of 1971, as amended (Act).1 In response, this Bookletter provides FCS institutions with specific guidance about: (1) the application of the independent credit requirements in § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e) to the purchase of participation interests and other interests in pools or portfolios (hereafter referred to as pools) of loans;2 (2) the authority of FCS banks and associations to participate with non-FCS lenders in loans to similar entities under sections [3.1](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%203.01.docx)(11)(B) and [4.18A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx) of the Act; and (3) lease participation authorities of FCS lending institutions and service organizations that are chartered under section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) of the Act.

 **I. How does the "independent credit judgment" requirement in §** [**614.4325**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)**(e) apply when an institution purchases an interest in a pool of loans from other FCS institutions or non-FCS financial institutions?**

 The independent credit judgment requirement of § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e) applies equally to an interest in a single loan or a pool of loans.3 The FCA recognizes that loan participation interests can effectively diversify loan concentration risk within an institution's portfolio.4 However, loan participation interests expose System institutions to other types of risks. Although these risks can be managed, FCS institutions must be aware of such risks, and take them into consideration when they decide whether to purchase a participation or other interest in such loans.

 The following passage from the preamble of the proposed regulation explains the FCA's reasons for requiring FCS institutions to conduct an independent credit analysis and reach an independent credit judgment when they purchase participation or other interests in loans:

[T]he purchase of participation interests or other interests in loans without adequate independent analysis to make an independent objective decision by the purchasing institution on the borrower's creditworthiness and the quality of the asset is an unsafe and unsound practice. . . . The FCA believes that these requirements are necessary to the effective discharge of the [purchasing institution] board's fiduciary responsibility to the institution's stockholders to ensure that adequate internal controls are in place to safeguard its assets.5

 The ultimate responsibility for the solvency of each System institution rests with its board of directors. For this reason, § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e) requires the board of each FCS bank and association to independently: (1) analyze the institution's exposure to various risks associated with the purchase of a participation interest or other interest in either an individual loan, or a pool of loans; and (2) decide whether or not the purchase of the interest in question furthers the business goals and risk management objectives of the institution. Under § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e), the board's accountability for such decisions cannot be delegated to a lead lender, agent, or other intermediary because such decisions directly impact the individual institution's solvency and viability.6

 **A. Does §** [**614.4325**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)**(e) require System banks and associations to exercise an independent credit judgment on every individual loan in a pool of loans?**

 **No.** Section [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e) requires an institution to exercise its independent credit judgment on any transaction to purchase a participation interest or other interest in an individual loan or pool of loans. However, § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e) provides an FCS institution with the flexibility to conduct a due-diligence analysis on a sample of loans in a pool in which the institution will purchase a participation interest or other interest. Such a due-diligence analysis should be based on safe and sound underwriting criteria consisting of a composite evaluation of credits through the use of appropriate techniques. The FCS institution must be able to justify its assumptions when it relies on such composite evaluation techniques. The analysis also should include an evaluation of the originator, lead lender, servicing agent, or other intermediary's management capabilities, underwriting policies, and servicing procedures. In addition, when an interest in a pool of loans is originated to conform with, or is purchased under, a common set of underwriting criteria, such as a credit scoring system, the analysis may involve a review of the underwriting criteria, together with a reasonable sampling of the loans sufficient to ensure the consistent application of the criteria.

 **B. Are there situations when a due diligence analysis of a sample of loans in a pool of loans will not satisfy the requirements of §** [**614.4325**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)**(e)? If so, when is a heightened level of review and analysis required for a pool of loans?**

 Although System institutions are authorized to perform a due-diligence analysis on a sample of loans in a pool, every institution is also expected to conduct a separate, in-depth analysis of any loan(s) in the pool that could significantly increase the institution's exposure to a material risk of loss. As a result, each System lender is expected to assess its own vulnerabilities to loss, and decide when a pool of loans, or any portion thereof, merits a higher level of scrutiny commensurate with the institution's risk-bearing and management ability.

 As an example, each System bank and association purchasing a participation interest or other interest in a pool of loans would be expected to conduct a separate analysis of individual loans that have characteristics concerning size, terms, conditions, or the nature of the borrower's enterprise that are significantly different from the majority of loans in the pool. To the extent that such individual loans pose greater risks of loss, prudence requires that the purchasing institution conduct an analysis of these individual loans separately from its due-diligence analysis on a composite sample of the rest of the loans in the pool.

 Similarly, an institution's risk of loss also may increase if it acquires an interest in a pool of loans that is substantially dissimilar and requires different expertise than management of its own portfolio of loans. In such situations, an FCS institution may not be familiar with the risks inherent in certain types of credit, therefore, the institution should apply a greater degree of review and analysis to the purchase of such participations making sure that the associated risks are properly identified and addressed.

 In addition, a higher level of review and analysis would be required if the purchase price of the interest of any of the individual loans within the pool equals a material portion of the System institution's capital. In contrast, a due-diligence analysis of a composite sample of loans in a pool would normally satisfy the requirements of § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(e) if the FCS institution purchases an interest in a pool of small loans that, in the aggregate, equals a material portion of the institution's capital.

 **C. Does §** [**614.4325**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)**(e) prohibit an FCS lender from delegating any decisions about the credit to a lead lender, agent, or intermediary?**

 **No**. The FCA has previously acknowledged that certain functions and decisions pertaining to credit administration may be delegated to a lead lender, agent, or other intermediary. The following passage in the preamble to the final regulation explains the FCA's position on the delegation of authority to outside parties:

The final regulation grants the participants some discretion to delegate, by contract, certain judgments or servicing actions to either the lead lender or an agent. The final regulation does not require all participants in a loan to review decisions on nonsubstantive matters. The FCA considers certain servicing actions, such as granting time extensions for certain reporting requirements, releasing non-material portions of collateral, or granting a reasonable forbearance for meeting defined financial covenants, as nonsubstantive in nature. . . . Nevertheless, the FCA continues to believe that each participant must independently review and agree to any action which substantively alters either the terms of the loan or the participant's interest therein.7

 As noted earlier, the subject of agent relationships and delegated authorities, by the institution to such agents, is addressed in more detail in the proposed Loan Underwriting regulations, which were adopted by the FCA Board at the March 12, 1996 Board meeting.

 **II. How do the "similar entity" authorities in sections** [**3.1**](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%203.01.docx)**(11)(B) and** [**4.18A**](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx) **of the Act expand the authority of System banks and associations to participate in loans with non-FCS lenders?**

 The Farm Credit Banks Safety and Soundness Act of 19928 and the Farm Credit System Agricultural Export and Risk Management Act9 granted System banks and associations new authorities to participate in loans originated by non-System lenders. These new statutory authorities have expanded the loan participation authorities of System lenders in two ways. First, the definition of "participation" differs for loans to (1) eligible borrowers and (2) similar entities. Section [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(a)(4) defines "participation" in a loan to an eligible borrower as "a fractional undivided interest in the principal amount of a loan. . . ." However, sections [3.1](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%203.01.docx)(11)(B)(iv) and [4.18A(](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx)a)(1) ("similar entity" authorities) of the Act define "participation" in a loan to a similar entity more broadly as "multilender transactions, including syndications, assignments, loan participations, subparticipations, or other forms of the purchase, sale, or transfer of interests in loans, other extensions of credit, or other technical and financial assistance," which may consist of a fractional divided interest in the loan. Second, the "similar entity" authorities authorize FCS banks and associations to participate in loans to borrowers who would not be eligible to borrow directly, provided that the ineligible borrower has operations that are functionally similar to the operations of eligible borrowers.

 In addition, the "similar entity" authorities of the Act impose three restrictions on participation interests by FCS banks and associations in loans to similar entities: (1) the total amount of credit that a System institution has outstanding to a single credit risk shall not exceed 10 percent (or such higher limit as authorized by FCA and approved by the institution's shareholders) of its total capital; (2) the "similar entity" authorities sections of the Act require that the participation interest(s) of one or more FCS institutions in the same loan cannot equal or exceed 50 percent of the principal amount of the loan at any time; and (3) the Act limits the amount of participation interests in similar-entity loans that each FCS bank or direct lender association may hold at any time to 15 percent of its total outstanding assets.

 On September 11, 1995, the FCA proposed § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx) to implement the similar entity provisions of the Act. *See* 60 FR 47103 (Sept. 11, 1995). As proposed, § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx) would not permit an FCS lender that operates under title I of the Act to participate with a non-System lender in a loan that a title II institution could make directly to the borrower, and vice versa. The comment letters about proposed § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx) indicate that some FCS institutions disagree with the FCA's interpretation of the Act, while other System institutions support it. The FCA is carefully considering the comments of all parties.

 **A. Is the "similar entity" status of a loan participation interest determined by the eligibility of the borrower or the lending authorities of the FCS institution? For example, could a Farm Credit Bank (FCB), or a Federal Land Credit Association (FLCA) participate with a commercial bank in a short- or intermediate-term loan to a borrower who is eligible to borrow directly from a production credit association (PCA)?**

 "Similar entity" status is determined by the characteristics of the borrower, not the lending authorities of the lender. Section [4.18A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx)(a)(2) of the Act defines a "similar entity" as a person who (1) is not eligible for a loan from either a Farm Credit bank that operates under title I of the Act or a direct lender association; and (2) has operations that are functionally similar to a person who is eligible to borrow directly from such bank or association in that the entity derives most of its income from, or has most of its assets invested in, activities that are permissible for eligible borrowers. In other words, a similar entity is an ineligible borrower who requires financing for a purpose which a System lender is authorized to finance.10

 If the entity is eligible to borrow from either a Farm Credit bank that operates under title I of the Act or a direct lender association, it is not a similar entity for any other title I or II lender, and the purchase of participation interests in loans to such borrowers is governed by sections [1.5](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%201.05.docx)(12)(C) and [2.4](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%202.04.docx)(a) of the Act, respectively, rather than section [4.18A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx). In addition, specific participation authorities for the various types of FCS institutions are addressed in part 614, subpart A of the FCA's regulations. Accordingly, participation in a loan to an eligible borrower must consist of a fractional undivided interest, and the loan terms must be compatible with the institution's lending authority.

 As an example, an FCB or FLCA could not purchase from a non-System lender a participation interest in a short- or intermediate-term loan that a PCA could make directly to an eligible borrower.11 Similarly, a PCA could not directly purchase a participation interest in a long-term mortgage loan from a non-System lender.12

 **B. Do the "similar entity" authorities of the Act enable FCS banks and associations to purchase from non-System lenders interests in loans, other than fractional undivided interests, to eligible borrowers?**

 **No**. Section [4.18A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx) does not expand the authority of an FCS lending institution to participate with non-System lenders in loans that such System bank or association could make directly to the borrower. As a general rule, System banks and associations lack authority to purchase from a non-System lender whole loans and interests (other than fractional undivided interests) in loans to eligible borrowers.13

**III. Can a service organization chartered under section** [**4.25**](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) **of the Act, such as the Farm Credit Leasing Services Corporation (FCLC), sell lease participation interests to FCS banks and direct lender associations and, conversely, can such FCS banks and associations purchase lease participation interests from such service organizations?**

 **Yes**. As an FCS service organization chartered under section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) of the Act, the FCLC has the same authorities, subject to limitations in its charter and articles of incorporation, as its parent institutions,14 except that it cannot extend credit or sell insurance.15 Therefore, despite the absence of any specific direction in subpart A of part 614 of the regulations pertaining to the FCLC's ability to purchase or sell participation or other interests in leases, section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) of the Act authorizes the FCLC to participate in or sell and purchase interests in leases to the same extent as its parents. However, the FCLC cannot purchase or sell participation interests or other interests in loans because the Act prohibits such section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) service organizations from extending credit to FCS borrowers.

 In addition, System banks and direct lender associations are authorized by the Act and FCA regulation to sell to and purchase from other FCS institutions participation interests and other interests in loans and similar credits.16  Therefore, FCS banks and associations are authorized to sell to and purchase from service organizations, such as the FCLC, participation interests and other interests in leases. The FCLC may also purchase from and sell to non-System institutions fractional undivided interests in leases to the extent of their parents' authority.

The FCA, with this Bookletter, has attempted to address some of the significant issues that have arisen pertaining to loan participation activities and participation authority issues related to the FCLC and other FCS institutions' leasing activities. However, there are other issues related to loan and lease participation activities that will require further analysis by the FCA. Such issues include: (1) lending limits and territorial concurrence for leases; (2) capitalization requirements; and (3) out-of-territory activities pertaining to leasing, loan participation, and the purchase and sale of loan interests. In addition, this Bookletter does not address whether service organizations that are chartered under section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) of the Act are authorized to engage in similar entity transactions. These additional issues will be dealt with in future bookletters or regulatory revisions.

If you have any further questions on these matters, please contact Dennis Carpenter, Senior Policy Analyst, at (703) 883-4256.

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1 For the purpose of this Bookletter only, the term "Farm Credit System institution" refers exclusively to System banks and associations.

2 Proposed § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(a)(1) would revise the definition of "interests in loans" to expressly include transactions involving a pool of loans. *See* FCA Board Action on Loan Underwriting Proposed Rule (BM-12-MAR-96-03).

3 *See* [57 FR 38237](http://ww3.fca.gov/readingrm/fedreg/Federal%20Register%20Documents/57%20FR%2038237.docx), 38241 (Aug. 24, 1992).

4 According to § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(a)(4), "participation interest" refers to a fractional undivided interest in the principal amount of any loan that a lead lender sells to a participating lender.

5 See [56 FR 2452](http://ww3.fca.gov/readingrm/fedreg/Federal%20Register%20Documents/56%20FR%202452.docx) (Jan. 23, 1991). The FCA reaffirmed this position in the preamble to the final regulations. See [57 FR 38237](http://ww3.fca.gov/readingrm/fedreg/Federal%20Register%20Documents/57%20FR%2038237.docx) (Aug. 24, 1992).

6 Proposed § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx) provides clarification and additional direction pertaining to the delegation of specific transaction authorities to agents. (See FCA Board Action on Loan Underwriting Proposed Rule (BM-12-MAR-96-03).

7 *See* [57 FR 38237](http://ww3.fca.gov/readingrm/fedreg/Federal%20Register%20Documents/57%20FR%2038237.docx) (Aug. 24, 1992).

8 Pub. L. No. 102-552, § 502, 106 Stat. 4130 (Oct. 28, 1992).

9 Pub. L. No. 103-376, § 2, 108 Stat. 3497 (Oct. 19, 1994).

10 See [60 FR 47103](http://ww3.fca.gov/readingrm/fedreg/Federal%20Register%20Documents/60%20FR%2047103.docx), 47115 (Sept. 11, 1995). However, section [4.18A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx)(b)(4) of the Act expressly precludes System banks that operate under title I of the Act and direct lender associations from participating in rural housing loans under their similar entity authorities.

11 One method for FCS institutions to facilitate such "eligible borrower" participation with a non-System lender would involve a PCA or agricultural credit association (ACA) serving as an intermediary, purchasing the participation interest from the non-System lender and then selling a participation interest to the FCB or FLCA. Similarly, a FCB, FLCA, or ACA would have to purchase an interest in a long-term mortgage loan and then sell an interest to the PCA.

12 Under sections [3.1](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%203.01.docx)(11)(B) and [4.18A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.18A.docx) of the Act, however, a party who is eligible to borrow from a title III lender may qualify as a similar entity for a System institution that operates under titles I or II of the Act, and vice versa. The definition of "participation" in sections [3.1](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%203.01.docx)(11)(B)(iv) applies to such transactions because, for example, the eligible title III borrower is a similar entity for the title I or II lender that is participating in the loan. Furthermore, the Act imposes consent requirements when a title I or II lender participates with a non-System institution in a loan to a similar entity that is eligible to borrow directly from a title III bank, and vice versa.

13 Farm Credit banks operating under title I of the Act and direct lender associations may only purchase certain qualified mortgage loans to eligible borrowers and interest therein from non-System lenders when they are pooling and securitizing loans for the Federal Agricultural Mortgage Corporation (Farmer Mac) pursuant to their respective authorities under sections [1.5](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%201.05.docx)(24), [2.2](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%202.02.docx)(21) and [2.12](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%202.12.docx)(22) of the Act.

14 Section 209 of the Farm Credit System Reform Act of 1996 (Pub. L. No. 104-105, 110 Stat. 162 (Feb. 10, 1996)) added a new section [4.28A](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.28A.docx), which revises the definition of "bank" in section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) to include "each association operating under title II" of the Act.

15 Section [4.25](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%204.25.docx) of the Act states that a Farm Credit bank or group of banks can organize a service corporation for the purpose of performing functions and services for or on behalf of the organizing banks " . . . **Provided**, that a corporation so organized shall have no authority either to extend credit or provide insurance services for borrowers from Farm Credit System institutions, nor shall it have any greater authority with respect to functions and services than the organizing bank or banks possess under this Act. . . ."

16 FCA regulations at § [614.4325](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4325.docx)(a)(3) define loans as any extension of credit or similar financial assistance of the type authorized under the Act, such as leases, guarantees, letters of credit, and other similar transactions.