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October 28, 1997

To: Chairman, Board of Directors

Chief Executive Officer

Each Farm Credit Institution

From: Marsha Pyle Martin

Chairman and Chief Executive Officer

Subject: Lending Policies and Loan Underwriting Standards Regulations

The Farm Credit Administration (FCA) Board recently granted final approval for regulations on Lending Policies and Loan Underwriting Standards that are included in 12 CFR [614.4150](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/614.4150.docx). This bookletter clarifies the approach and expectations that FCA will use to examine compliance by Farm Credit System institutions (institutions) with these regulations.

The newly promulgated regulations provide flexibility so institutions may tailor lending policies and loan underwriting standards in accordance with safe and sound business practices commensurate with the needs and capability of the institution and its members. Although these regulations eliminated the requirement that System lenders obtain a verifiable balance sheet and income statement from most borrowers at least annually, institution boards and management should remain cognizant of the responsibility to obtain current and reliable financial information on borrowers as needed to properly measure and manage risks within the loan portfolio, and determine the allowance for losses.

Institution boards should avoid practices resulting in conditions that existed prior to 1985 when many institutions were unable to accurately assess risk because they did not have and were unable to obtain current financial information from borrowers. The need for current financial information on borrowers becomes even more crucial to appropriately evaluate risk and the institution’s safety and soundness as conditions change in the lending environment or as conditions change under which loans were originally made. Therefore, in accordance with sound business practices, institutions will be expected to incorporate into borrower loan agreements (or any other legally binding instrument executed with the borrower at the time of loan closing) the requirement that borrowers provide at any time during the duration of the loan current, reliable, and verifiable financial statements (balance sheets and income statements) as requested by the lender subsequent to loan closing. This requirement should also be incorporated into legal instruments for lending programs that do not require verifiable or signed financial statements from borrowers at the initiation of a new loan. The failure of an institution to make provisions to obtain such financial information from the borrower upon request of the lender, or the failure to obtain current, reliable, and verifiable financial information from borrowers when conditions worsen in individual loans, segments of the loan portfolio, or the loan portfolio in its entirety, could be considered by FCA examiners as an unsafe and unsound practice that would require corrective action by the institution’s board of directors.

The regulations prescribe, in general, the contents expected in lending policy and loan underwriting standards. FCA examiners will review board policies and procedures to determine that loan underwriting standards are established and implemented for all lending programs that the institution plans to offer. The institution’s lending standards should be incorporated into such policies or procedures and establish the minimum credit and financial information required from borrowers. In considering this requirement, each institution should determine the frequency needed for the collection and verification of credit and financial information, commensurate with the risk in the loan and the type of credit extended, that will enable the institution to be kept apprised of the borrowers’ operating performance or risk inherent in the loan. Accordingly, each institution’s loan underwriting standards should include measurable standards to determine that the applicant has the operational, financial, and management resources to repay the debt from cash flow, and provide guidance on requiring collateral and other security as may be needed to ensure full collection of the debt in accordance with the terms established in the promissory note or other loan agreements.

The board of each institution should clearly prescribe its delegations of approval authority on loans, including delegations of authority to approve exceptions to underwriting standards. There should also be a process established for reporting to the board those actions taken under the authority delegated. Each institution should have internal control systems capable of monitoring compliance with loan underwriting standards and reporting exceptions to the institution’s board and/or management.

The institution’s underwriting standards should result in loans with acceptable risks, both on an individual basis and collectively as an entire portfolio. The FCA examiners will consider an acceptable level of risk as being risk which is commensurate with the institution’s capital protection and management’s ability to control risk. In this respect, the board of each institution should ensure that its loan underwriting standards are appropriate for the risk-bearing capacity of the institution within tolerances established by the board. Concentrations (whether they be by industry, loan size, or any other specialization) should be adequately measured and managed to limit the excessive exposure of capital to risk inherent in such loan portfolio segments. The board should also ensure that internal controls identify lending practices that may cause excessive risk or practices that threaten the financial condition of the institution so that prompt corrective actions can be taken.

Lending practices and loan underwriting standards should be reviewed periodically by board and management to ensure they appropriately preserve and strengthen the soundness and stability of the institution’s financial condition and performance and are compatible with the lending environment. Such reviews for example, should take into consideration: planned actions within the context of the institution’s strategic business plan to enter new market segments; changes in the economic, business, and lending environments; changes in government policies; changes in the institution’s financial condition and risk bearing capacity; changes in principal credit personnel; and other factors that might change in those operating conditions under which the loan underwriting standards were established.

While each of the issues as discussed in this letter provides direction that will be considered in measuring compliance with 12 CFR 614.4150, each institution’s board has the ultimate responsibility and fiduciary duty to ensure the institution operates in a safe and sound manner. Additional guidance in this area can be obtained by reviewing the FCA publication entitled The Director’s Role. Copies of that publication are available from the Office of Congressional and Public Affairs, FCA, 1501 Farm Credit Drive, McLean, Virginia 22102-5090.

If you have any further questions on these matters, please contact me or Roland E. Smith, Chief Examiner, at (703) 883-4160.