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March 10, 2016

To: Chair, Board of Directors

Chief Executive Officer

Each Farm Credit System Institution

From: Kenneth Spearman, Board Chairman and

Chief Executive Officer

Subject: Lending to Similar Entities

In this Bookletter, we, the Farm Credit Administration (FCA), provide guidance to Farm Credit System (FCS or System) institutions that purchase participations[[1]](#footnote-1) in loans originated by non-System lenders to qualified similar entity borrowers. We describe the policy, procedures, and internal controls that System institutions need if they participate in similar entity lending. These safeguards can help System institutions ensure compliance with 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 Farm Credit Act of 1971, as amended (Act) and FCA regulation 12 CFR § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx).[[2]](#footnote-2)

Similar Entity Authority

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 define a “similar entity” as a person or entity that is not eligible for a loan from a System bank or association, but has operations “functionally similar” to the operations of an eligible borrower under the applicable provisions of title I, II, or III of the Act, respectively. The qualified similar entity must derive a majority of its income from, or have a majority of its assets invested in, the conduct of activities that are “functionally similar” to the activities conducted by an eligible borrower.[[3]](#footnote-3) Additionally, the Act and § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx)(c) of FCA’s regulations set forth the following limits on similar entity transactions:

* *Exposure Limit:* The participation interest in the same loan held by one or more FCS institutions must not, at any time, equal or exceed 50 percent of the principal amount of the loan.
* *Obligor Limit*: The aggregate dollar volume of all similar entity participations that involve a single credit risk must not exceed 10 percent of an institution’s total capital; or 25 percent of total capital for a Farm Credit Bank[[4]](#footnote-4) or association as long as shareholders approve the higher limit.
* *Portfolio Limit*: The aggregate dollar volume of similar entity participations held by the institution must not exceed 15 percent of its total assets.

Purpose of Similar Entity Authority

Congress established the similar entity authority to provide System institutions and non-System lenders with a tool to manage risk. By lending to similar entities, System institutions can reduce geographic, industry, and individual borrower concentrations in their portfolios, and improve the results of their operations. The limits placed on System banks and associations reinforce that this authority must be used prudently and thoughtfully. Similar entity authority should not diminish in any way the System’s primary mission as a lender to farmers, ranchers, their cooperatives, and other eligible borrowers in rural America.

Determination and Criteria

The determination of whether a prospective borrower qualifies as a similar entity is based on the activities of eligible borrowers. FCA expects the principal activities of the similar entity to align with those of an eligible borrower. System institutions should not focus on incidental activities of eligible borrowers when they assess whether a prospective borrower is a qualified similar entity.

Expectations: Policy, Procedures and Internal Controls

Similar entity authority subjects the System to significant scrutiny from Congress, FCA, and the public because it permits the System to participate in loans to ineligible borrowers. For this reason, FCA expects System institutions to have robust due diligence practices in place before participating in similar entity loans. All System institutions that participate, or that plan to participate, in similar entity loans should have policy, procedures, and internal controls that appropriately identify, evaluate, and mitigate various risks associated with this authority.

**Policy and Procedures** – Establish a board policy and implement procedures that provide adequate guidance to staff pertaining to similar entity lending. Such policy and procedures would include the following:

* 1. **The institution’s risk management and diversification objectives**. These objectives include the following:
* How the institution will use this authority to mitigate risk in the loan portfolio based on geography, industry, and individual borrower concentrations
* Direction and risk parameters that reflect the board and management’s appetite for all types of risk (i.e., credit, market, strategic, compliance, and reputation)
* A description of the industries or borrowers that the board would want to avoid, as appropriate

1. **Criteria for assessing whether a borrower qualifies as a similar entity**. This process should ensure that the institution performs the following:
   * + Adequately assess whether the prospective borrower qualifies as a similar entity
     + Determine that the prospective borrower’s operations are principally involved in functionally similar activities
     + Comply with the limitations set forth in § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx)(c)
2. **Requirements that provide clear direction for analyzing a transaction**. The credit analysis should do the following:
   * + Show that the entity requesting the loan, (not the parent or subsidiary of the entity) is functionally similar
     + Describe the comparable directly eligible activities that the similar entity determination is based on, and the percentage of income and/or assets that the entity devotes to the similar activities
     + Complete a more robust analysis and documentation for those situations in which a similar entity becomes less focused on functionally-similar activities (In some cases, a System institution may need to obtain a legal opinion or consult with FCA.)
     + Describe the potential reputational risks that might result from the loan
3. **Periodic board reporting on similar entity loans**. Reports should be commensurate with the institution’s level of activity and potential risk. FCA expects the reports to include the following:
   * Credit quality statistics
   * Industry and large loan concentrations
   * Compliance with risk parameters
   * Compliance with the portfolio and obligor limits
   * An assessment of the risk diversification benefits resulting from participating in similar entity loans

**Internal Controls** – Establish adequate internal controls to identify, manage, monitor, and reduce risks and ensure compliance with policies, procedures, and applicable regulations. Such internal controls would include the following:

1. **A process to ensure FCS institution and System-wide ongoing compliance with the exposure limit in §** [**613.3300**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx)**(c)(2)**.
2. **Consideration of whether the obligor limits in §** [**613.3300**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx)**(c)(1) and the portfolio limits in §** [**613.3300**](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx)**(c)(3) are appropriate**. If not, more restrictive limits should be established.
3. **A loan approval process, including delegations of authority**. The process should consider the nature of risk (including reputation risk) in these transactions.
4. **Internal audit and review coverage of similar entity loan activity**. This would include a review identifying all types of risk. It would also include a review to ensure compliance with FCA regulations and the institution’s policies and procedures. FCA expects internal controls to require System institutions to report the results of reviews and corrective actions to their Audit Committees.

System institutions that have policy, procedures, and internal controls for similar entity lending should review and, if needed, revise them based on this guidance. Institutions planning to participate in similar entity lending that have not yet developed a similar entity policy, procedures and internal controls should use this guidance in developing them. Within 120 days of the date of this Bookletter, each System institution that engages or plans to engage in similar entity lending should submit its policy and procedures, as well as a description of its internal controls, to its examiner-in-charge. System institutions should also evaluate their compliance with previously issued guidance on reporting requirements.[[5]](#footnote-5)

FCA will continue to study and assess other issues and risks associated with System lending to similar entities. We may issue further guidance about similar entities that we deem necessary or appropriate.

If you have questions on this guidance, please contact Jeremy R. Edelstein, Senior Policy Analyst, Office of Regulatory Policy at (703) 883-4497 or [EdelsteinJ@fca.gov](mailto:EdelsteinJ@fca.gov), Richard Katz, Senior Counsel, Office of General Counsel at (703) 883-4085, or [KatzR@fca.gov](mailto:KatzR@fca.gov), or Donald Sullivan, Senior Portfolio Manager, Office of Examination at (703) 883-4273, or [SullivanD@fca.gov](mailto:SullivanD@fca.gov).

1. According to section [3.1](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%203.01.docx)(11)(B)(iii) of the Act and 12 CFR § [613.3300](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3300.docx)(a)(1), “the terms ’participate’ or ’participation’ refers to multi-lender transactions, including syndications, assignments, loan participations, sub-participations, or other forms of the purchase, sale, or transfer of interests in loans, or other extensions of credit, or other technical and financial assistance.” [↑](#footnote-ref-1)
2. For the purposes of this guidance, a qualified similar entity borrower is a person or entity who is ineligible for a System loan, but has operations that are functionally similar to those of an eligible borrower and, therefore, may obtain FCS credit under the applicable similar entity provisions of the Act. The term “qualified” is used instead of “eligible” to provide a clear distinction between similar entities and eligible borrowers [↑](#footnote-ref-2)
3. System banks and associations cannot use their similar entity authority to participate in rural home loans of the type authorized under section [1.11](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%201.11.docx)(b) or [2.4](http://ww3.fca.gov/readingrm/handbook/Statutes/SEC.%202.04.docx)(a)(2) of the Act and under § [613.3030](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/613.3030.docx) of FCA’s regulations. [↑](#footnote-ref-3)
4. A Farm Credit bank operating under title III of the Act does not have authority to increase its obligor limit above 10 percent of its total capital. [↑](#footnote-ref-4)
5. In October 2006, FCA sent all System institutions two documents: [Frequently Asked Questions Similar Entity Reporting](http://www.fca.gov/Download/FAQsSimilarEntityReporting.pdf) and a [flowchart](http://www.fca.gov/Download/ScheduleRC-OFlowchart.pdf). [↑](#footnote-ref-5)