



### EM-22.3

**Category:** Loan Portfolio Management

**Topic:** Credit Administration

**Published:** 7/16/2020

---

#### Overview

The *Credit Administration* topic provides guidance on evaluating a Farm Credit System (System) institution's guidance, standards, and controls over credit administration. Credit administration is defined as the processes and controls a lender uses to make and service a loan until it is collected. As used in this guidance, the term *loan* includes loans and leases outstanding as well as obligated but undisbursed commitments to lend or lease. Sound credit administration practices are necessary to appropriately identify, evaluate, and control the risks in any credit request or action. Weaknesses in credit administration can lead to poor credit decisions and expose an institution to excessive credit risk. While good loans sometimes go bad, strong credit administration ensures that appropriate controls are in place to proactively address credit deterioration and minimize credit losses.

Sound credit administration is critical for safe and sound operations. Accordingly, Farm Credit Administration (FCA) Regulation [614.4150](#) requires System banks and associations to adopt written standards for prudent lending, including written policies, operating procedures, and control mechanisms that reflect prudent credit practices and comply with all applicable laws and regulations. These standards should provide a credit administration framework that helps define the credit culture and risk appetite of the board and management. The adequacy of credit administration guidance and the extent to which it is followed has a direct impact on the risk embedded in the loan portfolio and management's ability to identify and manage this risk.

For examination purposes, the evaluation of credit administration is divided into the following subcategories that allow for a more targeted review:

- *Financial Information* – Collecting, verifying, adjusting, and consolidating financial information to evaluate risk and support the credit decision.
- *Credit Analysis and Decision* – Performing proper analysis to determine creditworthiness and support the credit decision, including addressing the five credit factors (capacity, capital, collateral, character, and conditions).
- *Loan and Legal Documents* – Obtaining, reviewing, preparing, executing, updating, and perfecting, as applicable, the loan and legal documents necessary to identify and enforce loan and collateral requirements.
- *Loan Terms and Conditions* – Using loan terms, conditions, and covenants to effectively control and monitor risk.
- *Loan Servicing* – Actively monitoring and managing the loan through servicing actions and plans to control risk and effectively communicate expectations to the borrower.

- *Delegated Lending Authorities* – Establishing and using delegated lending authorities, including required funding bank approvals, as a mechanism that ensures loan approval authorities are appropriate relative to staff’s experience, expertise, and performance and the size and risk of the exposure.
- *Disbursement/Payment Controls* – Establishing control processes around loan originations, disbursements, and payments to minimize the potential manipulation of loan proceeds or payments.
- *Eligibility and Authorities* – Assessing and documenting compliance with laws and regulations related to eligibility, scope of financing, and lending authority (including territorial concurrence).
- *Due Diligence* – Analyzing creditworthiness and verifying loan documentation to make an independent credit decision on purchased loan participations or syndicated loans.
- *Other Property Owned* – Maintaining and disposing of acquired assets to minimize losses to the institution.

In evaluating credit administration, examiners should focus first on the adequacy of the institution’s processes and internal controls. This includes evaluating credit administration guidance, board involvement in establishing guidance, and training to implement the guidance. This also includes determining whether controls ensure guidance is effectively implemented and regulatory requirements are met. A key part of this evaluation is validating the effectiveness of the independent internal review function. Examiners should conduct transaction testing to validate the adequacy of credit administration practices and controls and determine compliance with applicable institution guidance and regulatory requirements. Examination procedures and guidance for addressing each of these items, along with administration of direct loans to associations and other financing institutions (OFIs) by the Farm Credit banks, are discussed below in the *General Credit Controls* section. Additionally, there are procedures and guidance sections on *Regulatory Compliance*, which addresses several specific credit-related regulations, and *Administration of Specific Lending Programs*, which covers capital markets programs and scorecard lending (*guidance for the procedures in these sections is currently under development*).

Note: Credit administration can encompass many areas. For examination purposes, FCA has addressed certain aspects in other Examination Manual topics. For example:

- Loan underwriting standards and guidance are addressed in the *Loan Underwriting Direction* topic.
- Collateral evaluations and verification are addressed in the *Collateral Risk Management* topic.
- Loan pricing is addressed in the *Earnings Management* topic.

## Examination Procedures and Guidance

### General Credit Controls

#### **1. Credit Administration Guidance & Standards:**

Determine if guidance effectively communicates the necessary direction and standards to administer credit in a safe and sound manner.

#### Guidance:

Credit administration guidance should provide sufficient direction to properly identify and manage risk from loan application until the loan is ultimately paid off. The board is responsible for establishing lending policies and overseeing management's implementation of prudent lending practices. There is no one size fits all for credit administration guidance, and guidance can be communicated in many forms. In addition to policies and procedures, institutions may use credit memorandums, Loan Committee decisions, staff training programs, or other methods to communicate the board and management's credit administration expectations. It is important for the guidance to be clear, current, and easily accessible so it can be consistently implemented and result in credit administration practices that align with board and management expectations. How exceptions to guidance are processed and approved should also be addressed so staff can apply sound judgment when making credit decisions.

Evaluative questions and items to consider when examining credit administration guidance include:

- **Regulatory Compliance: Has the institution developed sufficient credit administration guidance and standards as required by FCA Regulation [614.4150](#)?** This regulation identifies the minimum requirements for credit guidance and standards that reflect prudent lending practices and ensure compliance with all applicable laws and regulations. The extent of credit guidance may vary depending on the complexity of lending activities and the institution's risk profile. Additionally, FCA Regulation [616.6300](#) requires that any leasing activity comply with the requirements in FCA Regulation [614.4150](#), and identifies additional policy and procedure requirements specific to leasing.
- **Financial Information: Does guidance sufficiently address financial information requirements?** FCA Regulation [614.4150\(a\)](#) requires that lending guidance prescribe the minimum supporting credit and financial information, frequency for collecting information, and verification of information required in relation to loan size, complexity, and risk exposure. Guidance should address both the acceptable age and reliability of financial information, as well as expectations for preparing financial projections. Guidance should also provide direction on adjusting applicant supplied financial information (e.g., current asset value updates, cost basis to market value adjustments, cash to accrual adjustments). The quality of financial information obtained and related verification requirements can range from collecting basic financial information for scorecard loans to requiring audited statements for large, complex operations. Refer to FCA's Informational Memorandums on [Loan Underwriting Standards - Borrower Financial Information](#) dated March 29, 2011, and [Servicing Loans to Borrowers in Distressed Industries](#) dated January 21, 2016, for criteria when evaluating financial information requirements. Additionally, the institution should have guidance on consolidating financial information when the credit decision is based on the financial condition of multiple borrowers or entities. The guidance should also address consolidating financial information from related borrowers that have loans meeting the

regulatory attribution criteria in FCA Regulation [614.4359](#).

- **Credit Analysis and Decision: Does guidance sufficiently address expectations for analyzing credit risk and making credit decisions?** FCA Regulation [614.4150\(b\)](#) requires each institution to develop procedures for credit analysis. These procedures should define the institution's approach to analyzing the five credit factors (commonly referred to as the 5 C's of credit) to conclude on the borrower's creditworthiness. Credit analysis guidance needs to incorporate measurable underwriting standards as required by FCA Regulation [614.4150\(g\)](#). As further specified in FCA Regulation [614.4150\(g\)\(1\)](#), the institution must have standards for determining whether an applicant has the operational, financial, and management resources necessary to repay the debt from cashflow. Additionally, FCA Regulation [614.4150\(i\)](#) requires that guidance address documentation of compliance with loan underwriting standards and compensating strengths when standards are not met. Refer to additional guidance in the *Loan Underwriting Direction* Examination Manual topic. The institution may choose to communicate credit analysis and decision-making guidance in conjunction with loan underwriting or risk rating guidance.
- **Loan and Legal Documents: Does guidance sufficiently address the loan and legal document requirements for making and servicing loans?** Guidance should identify and address the applicable loan and legal documents for making and servicing a loan. Most importantly, guidance should cover the documents necessary to evidence the debt obligation and secure the collateral, such as loan agreements, promissory notes, and security agreements. FCA Regulation [614.4200](#) requires these types of documents to identify the loan terms and conditions. Documentation requirements may vary depending on the size and type of loan and the type of collateral securing the loan. Guidance should include direction for perfecting security interests (e.g., filing financing statements, obtaining a mortgage or deed of trust), as well as lien certification requirements covered in FCA Regulation [615.5060\(a\)](#). There should also be guidance addressing documentation on loans to entities, as well as guidance for loans with guarantees or special conditions that would have additional documentation requirements. As a sound business practice, the institution should have processes to ensure documents are appropriately recorded and updated, as necessary. For example, the institution may use an independent, post-closing review of the documents that is differential based on risk.
- **Loan Terms and Conditions: Does guidance sufficiently address expectations for establishing loan terms and conditions?** Guidance needs to address requirements that loan terms and conditions be appropriate for the loan, in accordance with FCA Regulation [614.4150\(h\)](#). Loan amortization and maturity should be reflective of the expected useful life of the asset financed. Loan repayment structure should match the expected cash flow of the enterprise providing the primary source of repayment, and repayment should not be dependent on one-time, unusual sources such as the sale of collateral or production assets. If the institution uses balloon structures or interest only terms, guidance should provide direction on the appropriate use of these structures. Loan covenants and conditions provide lenders a mechanism for controlling risk in the account. Examples could include requiring financial covenants such as minimum working capital or equity, submission of borrowing base reports, or a credit enhancement such as a government guarantee. Guidance should also address other regulatory requirements related to loan terms and conditions, including:
  - FCA Regulation [614.4200\(a\)](#) requires that all terms and conditions be set forth in written documentation no later than loan closing.

- FCA Regulation [614.4200\(b\)](#) addresses security requirements based on the term of the loan, including the need for board policy to address any actions that will result in exceeding the loan-to-value limitation on long-term real estate mortgage loans. FCA's Informational Memorandum on [Clarification of FCA Regulation 614.4200\(b\)\(1\) – Security for Long-Term Loans](#) dated May 11, 2006, provides additional guidance on security requirements for long-term loans.
- FCA Regulations in Part 614, subpart A address maturity limits for short and intermediate-term loans as well as long-term mortgage loans. Loan terms must comply with respective lending authorities. Refer to the *Lending Authorities & Territories* procedure for additional details on examining compliance with these requirements (*this guidance is under development*).
- **Loan Servicing: Does guidance sufficiently address both routine and distressed loan servicing expectations?** Loan servicing involves monitoring, controlling, and managing a loan from origination through collection. Guidance should include expectations for all aspects of loan servicing commensurate with the risk in the account. This includes ongoing servicing of all loans and handling routine servicing actions, as well as the increased servicing needed on past due and higher risk accounts. FCA Regulation [614.4170](#) states that direct lenders are responsible for servicing loans they make unless otherwise designated in a participation agreement. This regulation requires that institutions develop loan servicing policies and procedures for term loans, operating loans, and loans to legal entities. Refer to the regulation for specific items that must be addressed. In addition:
  - Guidance should include expectations for routine servicing requirements, including monitoring compliance with general terms and conditions and formally documenting and communicating with the borrower any areas of non-compliance. Guidance should also address expectations for handling routine servicing requests (e.g., partial release of collateral, extensions, subordination requests, covenant waivers, release of insurance proceeds).
  - Guidance should establish the frequency for collecting financial information, performing subsequent lien searches, obtaining updated credit reports, and completing updated collateral evaluations. As outlined in FCA Bookletter [BL-037](#), it's the institution's responsibility to obtain current and reliable financial information on borrowers to properly measure and manage risks in the loan portfolio and determine the allowance for losses. Timely identification of adverse trends and conditions helps the institution address factors that have increased risk before loan collectability is materially impacted.
  - Guidance should address loan servicing plans. Loan servicing plans are an effective tool for outlining servicing actions on credits that require additional attention beyond the controls and monitoring established at origination. In most cases this would involve criticized loans but could also include large or complex loans or other material exposures that are classified Acceptable but showing increased risk. Guidance should define when loan servicing plans are necessary, how frequently they are to be updated, and what information should be included. Refer to FCA's Informational Memorandum on [Servicing Loans to Borrowers in Distressed Industries](#) dated January 21, 2016, for additional guidance on loan servicing. Also, [FCA Board Policy Statement 71 - Disaster Relief Efforts by Farm Credit Institutions](#)

provides considerable flexibility under FCA Regulations to provide disaster relief to borrowers.

- **Eligibility and Authorities: Does guidance sufficiently address institution lending authorities and borrower eligibility and scope of financing requirements?** Guidance should cover determining and documenting compliance with laws and regulations related to eligibility, scope of financing, and lending authorities (including territorial concurrence). This should include policy and procedure direction addressing the board and management's definitions and expectations for financing a farmer's nonagricultural needs, land in transition, and similar entities if the institution lends or intends to lend in these areas. Refer to the *Eligibility & Scope of Financing* and *Lending Authorities & Territories* procedures for more detailed guidance on examining these areas (*this guidance is under development*).
- **Due Diligence: Does guidance sufficiently address due diligence when purchasing interests in loans?** An institution that purchases loans and leases must have guidance to comply with FCA Regulation [614.4325\(c\)](#), which covers analyzing borrower creditworthiness and verifying loan documentation to make an independent credit decision on participated or syndicated loans. Refer to the *Loan Purchases & Sales* procedure for more detailed guidance on examining this area (*this guidance is under development*).
- **Other Property Owned (OPO): Does guidance sufficiently address managing OPO?** FCA Regulation [621.6\(d\)](#) defines OPO as any real or personal property, other than an interest-earning asset, that has been acquired as a result of full or partial liquidation of a loan. An institution should have guidance to ensure OPO is appropriately managed and disposed of. This may include expectations for acquiring title, maintaining the property, marketing the property, and complying with state and local laws. All sales and leases of OPO must comply with right of first refusal requirements, as addressed in the *Borrower Rights Examination Manual* topic. Additionally, for information on accounting and reporting OPO, refer to the *High-Risk Asset Accounting* procedure guidance in the *Risk Identification* topic.
- **Guidance Updates: Does the institution have processes that ensure credit administration guidance remains current and relevant for the lending environment?** As discussed in FCA Bookletter [BL-037](#), the board and management should periodically review lending practices and standards to ensure they remain appropriate. Credit administration guidance needs to be updated on an ongoing basis for changing risk conditions, new or revised lending programs, new lending authorities, changes in regulatory guidance, staffing changes, and any other material changes in the lending environment. For example, guidance updates may be needed if the institution becomes involved in a new program such as capital markets lending or when there is a concentration in a commodity that is under stress. Guidance should be dynamic and change with the risk environment.
- **Communication of Guidance: Do communication processes ensure staff are aware of and understand credit administration guidance?** The institution should adequately communicate to staff the requirements for administering credit. Credit guidance should be easily accessible to employees, and management should have a process for effectively communicating credit guidance changes. Examiners can use internal review results and FCA's transaction testing to evaluate the effectiveness of credit administration guidance and how well it appears to be understood and followed by staff.

Note: Loan pricing practices, loan underwriting direction and standards, and collateral administration relate directly to credit administration but are not specifically addressed above. Refer

to the applicable Examination Manual topics (*Earnings Management*, *Loan Underwriting Direction*, and *Collateral Risk Management*, respectively) for information on examining guidance and standards in these areas and consider the results when concluding on the adequacy of credit administration guidance. Additionally, refer to FCA Examination Bulletin [2009-2](#) when examining guidance on financing land in transition at institutions involved in this type of lending.

## **2. Internal Controls:**

Evaluate the adequacy of internal controls used to ensure credit administration guidance is appropriately implemented.

### Guidance:

Internal controls are the processes established by the board and management to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance. Internal controls related to administering credit should provide the board and management reasonable assurance that safe and sound credit administration practices are being followed and events of noncompliance will be detected in a timely manner. Internal controls should also ensure that credit administration practices are sufficient to identify and manage the key risks in each loan and the aggregate risk in the portfolio. Breakdowns in controls can result in poor customer service, inaccurate financial reporting, delayed risk identification, and in worst case scenarios, fraud.

As discussed in the *Credit Administration Guidance & Standards* procedure, institutions need to establish effective credit administration guidance. To ensure guidance is followed, institutions need to establish appropriate internal controls. FCA Regulation [618.8430](#) requires boards to adopt an internal control policy that provides adequate direction for establishing effective controls and accountability over operations, programs, and resources. Additionally, FCA Bookletter [BL-069](#) stresses the importance of board oversight, including the board's responsibility to establish a strong control culture within the institution by communicating expectations and holding management accountable for the design and effectiveness of lending and loan servicing controls. Refer to these documents, along with the guidance below, when evaluating the adequacy of internal controls related to credit administration.

The types and extent of internal controls may vary with the complexity and risks of the institution. However, each institution's board and management need to implement effective internal control processes to ensure proper credit administration. Examples include documented guidance, standardized forms, checklists, delegated lending authorities, loan committees, management supervision, and segregation of duties, as well as internal audit and review coverage. Properly functioning lending controls should result in the approval of loans that are consistent with the board's risk appetite. They should also deter lending staff from engaging in fraudulent lending activities that could result in financial losses, potential litigation, and diminished reputation. Effective control processes should generate a clear audit trail and include systems to flag exceptions and identify irregularities.

Note: This section focuses on the first and second lines of defense in the lending control framework, which are the controls implemented by front-line operating managers and credit risk managers to own, manage, and monitor risks. To evaluate the third line of defense, which involves internal audit providing independent assurance of the control framework, refer to the *Audit/Review* procedure. Additionally, refer to the *Transaction Testing* procedure for FCA review of loans to evaluate the effectiveness of lending controls.

Evaluative questions and items to consider when examining internal controls related to credit administration include:

- **Segregation of Duties: Are credit administration duties and functions reasonably separated to prevent errors, fraud, or unauthorized actions?** The possibility of errors and fraud diminishes significantly when there is a segregation of duties – that is, when two or more people are required to complete a transaction. The segregation of duties allows one person to verify that transactions initiated by another employee are properly authorized, recorded, and settled. When establishing segregation of duty standards, management should assign responsibilities so that one person cannot handle a transaction from inception to completion. For example, a loan officer should not perform more than one of the following tasks: originate a loan, disburse loan proceeds, or accept loan payments. Individuals with authority to sign official checks should not reconcile check ledgers or correspondent accounts, and personnel that originate transactions should not reconcile the entries to the general ledger. FCA Bookletter [BL-069](#) provides more information on segregation of duties and lending controls. In addition, the adequacy of segregation of duties around the lending function is an integral part of internal controls over financial reporting (ICFR), which is addressed in the *Financial Reporting Controls* procedure in the *Financial & Shareholder Reporting Examination Manual* topic.
- **Disbursement/Payment Controls: Does the institution have well-defined processes for loan origination, disbursements, and payments?** The institution should have processes and controls to minimize the potential manipulation of loan proceeds or payments. For example, controls should ensure only legitimate, approved loan requests are funded, that funds disbursed are received by the intended parties and used for the intended purposes, and that loan payments received are deposited and credited to the appropriate borrower’s account. This component of credit administration extends beyond the credit function to loan accounting, information systems, and other departments or staff. FCA Regulation [614.4150\(c\)](#) requires that guidance outline the minimum requirements for disbursement, servicing, and collections. Depending on the institution’s staffing and complexity, processes may require different types of controls to disburse loan proceeds or apply loan payments. Segregation of duties in this area is critical and in cases where full segregation of duties is not practical, management should identify ways to compensate for the risk (e.g., dual custody, post review processes). FCA Bookletter [BL-069](#) provides additional information on loan origination, disbursement, and payment controls.
- **Delegated Lending Authorities (DLA): Does management’s system of internal controls include reasonable DLAs to control loan and credit action approvals?** FCA Regulation [614.4150\(e\)](#) requires the institution to maintain guidance on loan approval delegations. The use of DLAs, including the use of loan committees and funding bank approvals, provides a mechanism that controls loan decisions. Complacency with DLAs can allow opportunities for inappropriate behavior or fraud. Approval authority levels should be set and periodically updated based on experience, expertise, and performance of lending personnel in relation to the risk that loans present to an institution’s capital and earnings. To evaluate the adequacy of current DLAs, the institution might track the quality and performance of loans approved within an individual’s DLA as well as internal credit review grades, if assigned. More restrictive delegations are common for higher-risk credit actions, such as loans with less favorable risk ratings (Probability of Default or Loss Given Default) or underwriting exceptions, unsecured loans, newer lending programs, project or construction financing, loans to specialized industries or with specialized collateral, out-of-territory loans, etc. DLAs



should be set based on total customer attributed commitment and not just individual loan size. There should also be controls in place to ensure all loan transactions that exceed DLAs are identified and go through appropriate approval channels. Once a loan is approved, controls should be in place to ensure that any material modifications require reauthorization through the appropriate approval channels. Likewise, controls should ensure funding bank approvals are obtained when required per FCA Regulations [614.4460](#) and [614.4470](#). FCA Bookletter [BL-069](#) provides additional information on ensuring proper use of DLAs.

- **Loan Committees: Does the Loan Committee serve as an effective control to ensure sound credit decisions on significant loan exposures? Does the committee function reinforce a commitment to sound credit administration?** Loan committees should ensure the loans they review or approve reflect prudent credit decisions and credit administration practices that adhere to the institution's guidance. If the Loan Committee approves loans with credit administration weaknesses, it makes enforcing the institution's credit guidance more difficult. Loan committees are usually comprised of the institution's most competent and experienced lending staff, who should set the tone regarding credit administration expectations. Committee meetings should occur with enough frequency to ensure timely loan review and approval, as well as timely feedback to lending staff. In addition, Loan Committee practices should ensure involvement early and often in the loan making and servicing processes. Loan Committee approvals should be adequately documented, with evidence in loan files that committee input and any conditions of approval were appropriately addressed.
- **Staff Training and Expertise: Do staff have the necessary training and expertise to adequately administer credit?** Management should ensure lending staff have the knowledge and tools to make and service loans in accordance with the institution's credit administration expectations. In addition to highly trained lending staff, management should ensure staff performing back office functions, such as loan documentation, are trained to understand their roles within the framework of strong credit administration. The institution should ensure cross-training and contingency planning are in place, so it is not overly reliant on a single employee to handle critical components of credit administration.
- **Management Review and Supervision: Does management review the effectiveness of the credit controls noted above and monitor and hold staff accountable for adherence to credit administration guidance?** Management needs to periodically review credit controls to ensure they remain effective as conditions and operations change. In addition, management should have processes to review employee adherence to credit administration guidance apart from the independent internal credit review function. Systems should be in place to oversee credit staff's work and ensure desired results are achieved. This goes beyond reviewing adherence to guidance. It includes ensuring credit staff are making sound lending decisions, particularly in unique or exceptional cases (e.g., a loan that complies with guidance but has other credit factor weaknesses that warrant loan denial or risk-mitigating controls, or a loan that doesn't comply with guidance but has offsetting strengths that support approval). The institution should also consider how to tie credit administration results to performance evaluations and compensation. Incentive plans and the performance appraisal process can have a significant effect on adherence to credit guidance and direction if administered appropriately. Refer to the *Employee Compensation and Performance Standards & Evaluations* procedures in the *Human Capital Management Examination Manual* topic for more detailed guidance on examining these areas.

Note: Examination of internal controls around the lending function is also closely tied to examination work completed in other areas, such as financial reporting controls, segregation of collateral evaluation duties, and access controls to electronic data. Refer to the applicable Examination Manual topics (*Financial & Shareholder Reporting*, *Collateral Risk Management*, and *Information Technology & Security*, respectively) for information on examining internal controls in these areas and consider the results when concluding on the adequacy of credit administration internal controls.

### 3. **Audit/Review:**

Determine if the institution conducts an effective audit/review (scope, reporting, and followup) of credit administration.

#### Guidance:

The internal audit and review function is a key component of an institution's credit control systems and is essential for detecting weaknesses in credit administration. FCA Regulation [618.8430\(c\)](#) requires each institution to establish an internal control policy that provides adequate direction for a program to review and assess its assets. With respect to credit administration, such a program must include standards that address loan review, including scope of review selection, workpapers, and supporting documentation, as well as standards for assessing credit administration and training to initiate the program. A major component of this is an independent internal credit review program (also commonly referred to as an internal review, audit, or asset review), which may be staffed with internal or externally-sourced resources.

An independent internal credit review program provides the board reasonable assurance that credit is being extended and serviced in a prudent manner. An effective program is critical to the board's ability to monitor asset quality, compliance with laws and regulations, and adherence to lending policies and procedures. In addition to individual loan reviews, an effective program includes an evaluation of internal controls over the credit administration function. The program should alert the board and management to credit administration weaknesses prior to them becoming severe enough to materially impact portfolio quality and financial performance.

The time, attention, and resources the board devotes to the independent internal credit review program are reflective of the institution's credit culture and commitment to ensuring sound credit administration. The internal review staff needs to possess the knowledge and skills to evaluate the credit administration function and should be independent from the lending function. This helps preserve objectivity and ensures that management does not have undue influence over the process. Failure to maintain a reliable and effective internal review process is an unsafe and unsound practice.

Note: This procedure focuses on evaluating the reliability and effectiveness of internal audits and reviews in this topical area. Refer to the *Audit & Review Programs* topic in the Examination Manual for guidance on examining the overall internal audit and review program.

Evaluative questions and items to consider when examining an institution's internal review of credit administration include:

- **Audit Coverage: Is there periodic audit or review coverage of credit administration?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan.

The risk assessment process should consider any new lending programs or initiatives, high-risk industries, portfolio segments with a high growth rate, areas with prior concerns, and any other areas where credit administration is critical or may be suspect. Without adequate consideration of these areas, the scope, depth, and frequency of reviews may be insufficient to detect weaknesses in credit administration. While most aspects of credit administration are evaluated as part of the internal credit review, segregation of duties and controls around loan origination, disbursements, and payments may also be tested as part of other audit activities.

- **Scope and Depth: Are audit or review scope and depth sufficient to conclude on the adequacy, completeness, and timeliness of credit administration processes?** The scope should cover the primary processes and controls within the area being audited or reviewed. The depth of work, including transaction testing, should be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of reviews should also be dynamic, with the ability to change as conditions warrant. The scope and depth of coverage should be consistent with the approved audit or review plan and engagement contract (if applicable). If audit or review work deviated materially from the original planned scope, the board (or Audit Committee, if so delegated) should be notified of the reasons for the change. Specific items that should be considered in the audit or review scope include:
  - Overall adequacy of credit administration processes. Internal audits or reviews should address all the major credit administration areas, including financial information, credit analysis and decision-making, loan terms and conditions, loan and legal documents, and loan servicing, as well as due diligence on purchased loans. Additionally, eligibility and authorities requirements, delegated lending authorities, and loan origination, disbursement, and payment controls should be evaluated.
  - Credit administration practices related to different types of lending or credit delivery processes (e.g., operating, intermediate-term, and long-term loans, capital markets programs, scorecard lending, or rural home programs).
  - Credit administration policies, procedures, and other guidance.
  - Staff adherence to policies, procedures, delegated lending authorities, and other guidance related to credit administration. Internal audits or reviews should include sufficient testing of lending controls to evaluate compliance with established policies, procedures, and regulatory guidance, and deviation from sound business practices.
  - Management of all significant credit analysis and scoring models, including consistency with the institution's overall model risk management framework.
  - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.
  - Periodic, onsite branch or regional audits and reviews, including review of some loan transactions without advance notice.
- **Loan Sampling: Was an appropriate loan sampling process used?** It is important to understand how the loan sample was selected to determine if relevant information was considered. The loan sampling methodology should evidence appropriate use of data tools

to target specific risk factors. For example, a loan sample may be based on specific loan attributes (e.g., size, risk rating, commodity, region) or other factors such as commodity specific adversity, changes in lending staff, or previously identified credit administration weaknesses. If a loan sample is targeted to test specific internal controls related to credit administration, that should be specified and supported. The loan sample methodology should be clearly documented and reported.

- **Reliability of Results: Did FCA identify any concerns with audit and review reliability?**  
Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing of transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. Often, auditors and reviewers will complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant documents when conducting work. If a grading system was used (e.g., A/B/C), the grades should be reasonably supported and consistently applied. Workpapers should adequately document the work performed and support the final report. In addition, any proforma work programs, workpapers, or other tools should be accurate and sufficiently thorough. If there are material weaknesses identified by examiners that are not identified by internal audits or reviews, examiners should assess the underlying reasons. Even if the differences in results are attributed to differences in the loan samples for the reviews, the scope and overall effectiveness of the internal review process should be thoroughly investigated. Examiners should also consider the results of any reviews completed by the funding bank or others.
- **Reports: Do internal review reports sufficiently communicate credit administration review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:
  - Is the report prepared in accordance with the institution's guidelines?
  - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?
  - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations?
  - Are conclusions and recommendations realistic and reasonable, with material and higher risk issues clearly identified and prioritized?
  - Are conclusions and recommendations supported by convincing evidence, persuasive arguments (condition, criteria, cause, and effect), and adequate workpaper documentation on individual assets reviewed?
  - Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?
  - Does the report address potential vulnerabilities to fraud, if applicable?

- **Corrective Action: Are management responses to review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management should also promptly correct credit administration weaknesses on individual loans as recommended by internal review. While it is typical for reviewers to discuss weaknesses with management to validate facts, there should not be a significant delay between receipt of internal review conclusions and when the appropriate actions are taken. In some cases, management commitments and agreements or any areas of disagreement are documented in the report or in a separate memo or tracking system. If corrective actions are not resolving the issues or concerns (based on repetitive audit findings, FCA findings, etc.), examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

#### **4. Transaction Testing:**

Examine individual loans to assess compliance with the institution's credit administration guidance and applicable laws and regulations, and to evaluate effectiveness of internal controls, including the reliability of the internal credit review function.

##### Guidance:

Loans and loan-related assets are examined, in part, to determine if the institution is administering credit in a safe and sound manner and in compliance with regulatory guidance. This includes determining if credit administration policies, procedures, and internal controls are working as intended and producing the desired results. The extent and focus of credit administration testing on individual loans should depend in part on the conclusions reached when completing the various *Credit Administration* examination procedures. If examination results indicate the institution has adequate credit guidance and effective internal controls (including independent internal credit review coverage and reliability) in place to ensure sound credit administration practices, limited testing of individual loans to verify these conclusions may be all that is necessary. The loan sample may need to be expanded if examiners identify weaknesses in lending guidance or control processes, or transaction testing results indicate that policies, procedures, and controls are not being followed, functioning as intended, or achieving the desired results. Alternatively, if conditions warrant, we may ask the institution to complete an independent review to fully test whether controls are working as intended.

**Selecting the Examination Focus Areas and Loan Sample:** FCA's transaction testing should be targeted toward areas of risk or potential concerns identified during ongoing oversight and examination activities. The adequacy of credit administration guidance and reliability of control processes, including the independent internal credit review, are important factors to consider. Examiners should also consider factors such as:

- Previous examination, internal review, or other third-party testing and results
- Changes to credit guidance and the internal control environment
- Changes in lending operations or programs
- Changes in management or lending staff

- Risk, growth, and trends in the loan portfolio
- Economic conditions and any distressed industries
- The institution's financial condition and performance

Based on a review of these factors, transaction testing should focus on evaluating the specific components of credit administration that represent the greatest risk exposure. This allows examiners to complete a more targeted review of specific aspects of credit administration. For example, if a portfolio is experiencing stress and credit quality deterioration, it may be more appropriate to focus resources on loan servicing rather than areas like eligibility and authorities. If there are potential concerns with segregation of duties, a focus on loan disbursements and payments may be warranted for appropriate actions and potential fraud exposure. Examination teams may not have the time or resources to complete a full evaluation of all aspects of credit administration. Selecting only the higher priority areas will allow for more in-depth coverage and meaningful examination results. If weaknesses in other areas emerge during the review, additional credit administration focus areas can be added to the examination scope.

After identifying credit administration areas to test, examiners will need to select the loan sample. Examiners should select the types of loans that will enable them to effectively conclude on the areas being tested. For example, you would typically select new loans or loans with recent credit actions to test areas such as credit analysis and decision, financial information, or delegated lending authorities. Loan servicing can be tested on a wide range of loans but is especially important on loans that have a criticized classification, past due loans, and loans in distressed industries (including large loans that are classified Acceptable but are experiencing stress).

**Evaluating Testing Results:** When evaluating results and developing conclusions from transaction testing, examiners should focus on the adequacy of credit administration in each examination area. The results should assist in answering the following key questions:

- Is the institution administering credit in a safe and sound manner and in compliance with regulatory requirements?
- Is credit guidance effective in ensuring sound loan administration practices and is it accomplishing the desired results?
- Are internal controls functioning effectively to ensure adherence to credit guidance and sound credit decisions?
- Is the independent internal credit review accurately assessing credit administration and identifying practices that could lead to increased portfolio risk? Do the credit administration weaknesses identified by FCA align with those reported in internal review reports?
- Are management's corrective actions effective in preventing the recurrence of previously identified credit administration weaknesses?
- Does a pattern of weak or unsatisfactory credit administration practices exist? Are any weaknesses material on either a loan specific basis or in aggregate?
- Do weaknesses contribute to inaccurate or untimely risk identification or reduce the likelihood of full collection, or are they technical in nature (minor omissions that would not impact the lending decision)?

- Are weaknesses confined to a specific loan officer, branch office, loan type, lending program, or another common characteristic?

##### **5. Direct Loan & OFI Administration (banks only):**

Evaluate the adequacy of guidance, standards, and controls used to administer direct loans to associations and “other financing institutions” (OFIs).

###### Guidance:

Farm Credit banks (banks) need to implement policies, procedures, and controls for administering direct loans to associations and OFIs. Consistent with the extension of any credit, the banks are required to evaluate the creditworthiness of each of their affiliated associations and OFIs. Therefore, each bank should ensure its credit administration guidance and practices are sufficient to identify and manage the risk presented by the associations and OFIs it finances. Much like loans to retail borrowers, the bank should structure direct loans with appropriate terms and conditions that mitigate the key risks in the lending relationship. These terms and conditions should be outlined in the general financing agreement (GFA) or the related promissory note. Ongoing monitoring and servicing of these loans should be reflective of the lender’s risk profile, with more extensive oversight and communication as the risk profile increases. Guidance should also govern how the bank will exercise its supervisory responsibilities over associations. The bank will typically administer most of these responsibilities through the GFA, but there are other administrative responsibilities that banks must fulfill to meet specific regulatory requirements and the Farm Credit Act of 1971, as amended (the Act). Banks are also tasked with oversight of the associations’ ICFR to help ensure reliability of System financial reporting. Each bank should have processes in place to ensure associations and OFIs are complying with their respective policies and procedures as well as laws and regulations.

Evaluating direct loan administration has similarities to evaluating retail loan administration. As such, the guidance and evaluative questions covered earlier in the *Credit Administration Guidance & Standards* and *Internal Controls* procedures generally apply when evaluating direct loan administration. Examiners should use this guidance, as applicable. Other evaluative questions and items to consider when examining direct loan administration include:

- ***Policies and Procedures: Does the bank maintain appropriate lending policies and procedures specific to administering direct loans to associations and OFIs?*** FCA Regulation [614.4120](#) requires the board of each bank to adopt policies and procedures governing extension of credit to associations and OFIs. In addition to the specific requirements identified in the regulation, effective policies and procedures should address items such as the underwriting, monitoring, and servicing of direct loans, similar to credit administration guidance for the retail portfolio. The following addresses several specific considerations and requirements for bank guidance:
  - Does guidance ensure that direct loans are extended through a GFA as required by FCA Regulations [614.4125](#) (associations) and [614.4130](#) (OFIs)? Refer to the regulations for specific requirements related to GFAs.
  - Do policies and procedures prescribe sufficient guidance to determine the lender’s creditworthiness? The bank should have comparable and objective loan underwriting standards and pricing requirements for OFIs and associations. The bank should consider risk factors such as adherence to capital requirements,

repayment ability, asset quality, liquidity, quality of collateral, business plan objectives, and quality of board and management.

- Has guidance been established to ensure appropriate loan servicing? Servicing should be reflective of the borrower's risk profile, with the expectation for more extensive oversight and communication as the risk profile increases. The bank should develop loan servicing plans identifying strategies for higher risk or adverse direct loans to mitigate the risk of loss. Bank guidance should also address the FCA notifications and consents required by FCA Regulation [614.4125](#) related to administering loans to associations.
- Does guidance address the bank's supervisory role and oversight responsibilities? Guidance should include board policies that clearly reflect the bank's supervisory responsibilities and the board's expectations of management in carrying these out. This would include the board's expectations for administering the general supervisory relationship over affiliated associations provided for in section [1.5 \(13\)](#) of the Act. The Act and regulations also require bank approval of, authorization of, or other involvement in specific association activities and operations. Policies and procedures should reflect these specific responsibilities and be sufficient to ensure ongoing compliance with regulatory requirements.
- Does guidance for OFI lending address compliance with FCA Regulations in Part 614, subpart P? Guidance should address:
  - Criteria and eligibility requirements for OFIs to have access to funding, discount, or similar financial assistance from a funding bank as required by FCA Regulations [614.4540](#) and [614.4560](#). In addition to specific policy, procedure, pricing, and loan underwriting standard requirements in FCA Regulation [614.4540\(c\)](#), these regulations identify numerous other requirements for administering credit to OFIs that should be addressed in the bank's guidance.
  - Requirements in FCA Regulation [614.4570\(c\)\(1\)](#) related to supplemental collateral or other credit enhancements for OFIs. Guidance should also address other collateral requirements as well as recourse and guarantee expectations for OFIs to ensure compliance with FCA Regulation [614.4570](#).
  - Limitations on the amount of financing provided to OFIs in relation to capital, as prescribed by FCA Regulation [614.4580](#).
  - Equitable treatment of OFIs and associations regarding underwriting standards, interest rates, fees, and capitalization requirements, as required by FCA Regulation [614.4590](#).
- **Internal Controls: Does the bank have sufficient internal control processes in place to ensure compliance with its guidance for administering direct loans?** The bank should have controls such as segregation of duties, delegated lending authorities, loan committees, staff training, and management supervision to ensure direct loan administration guidance is implemented as intended. This should also include internal audit and review coverage to evaluate the bank's direct loan administration guidance, processes, and controls to ensure they are functioning as intended. Additionally, given the importance of the GFAs, the bank



should implement a review process to ensure all legal documents, including the GFA, note, and collateral instruments, are legally executed and perfected.

- **Adherence to Lending Guidance: Does the bank follow its lending guidance when administering direct loans?** The bank should maintain sufficient documentation to ensure credit decisions and servicing actions are handled consistent with its lending guidance and are supported by appropriate analysis and legal documentation.
- **Direct Loan Monitoring: Is the bank effectively monitoring risk by routinely evaluating association and OFI financial condition and compliance with the GFA?** The bank should monitor compliance with loan terms and conditions, which are outlined in the GFAs. While GFAs can have up to a 5-year term, the bank should complete an annual review of each direct loan to ensure timely risk identification and servicing. The frequency and depth of monitoring direct loans, including compliance with GFAs, should be commensurate with risk exposure and comply with bank loan servicing guidance. As part of monitoring direct loans, the bank should also have processes to validate the quality of assets securing the direct loans. Specific to associations, the bank should also validate that ICFR meet the requirements in the GFAs. The following questions elaborate on these control processes:
  - *Collateral Monitoring* – Does the bank have a process to ensure that associations and OFIs have adequate risk identification and credit administration? The bank should validate each lender’s risk identification and credit administration to ensure asset quality and collateral risk are adequately reported and monitored. Since System institutions are required by FCA Regulation [618.8430\(c\)](#) to have an asset review program, the bank should also compare its results to those from each association’s review activities to ensure the associations’ audit and review functions are reliable. The bank should also ensure that association long-term mortgage loans meet the first lien requirements in FCA Regulation [615.5060\(a\)](#). If an association cannot provide proof of a perfected first lien position within 1 year of loan origination, the loan must be removed from collateral for the direct loan.
  - *ICFR Oversight* – Does the bank evaluate each association’s ICFR program to ensure compliance with the GFA ICFR covenant? While each association is responsible for evaluating the design and effectiveness of its ICFR, the bank’s program level review should ensure alignment with stated expectations in support of the combined System financial statements. The adequacy of an association’s ICFR program could potentially impact System disclosures, so the bank should ensure its associations have implemented ICFR programs in line with the agreed upon framework established by the Federal Farm Credit Banks Funding Corporation. This should include reviewing each affiliated association’s ICFR program design and processes with such scope and frequency as the bank determines, considering whether the association obtains an integrated audit opinion (entities that receive an integrated audit may not be subject to the bank’s GFA ICFR program review). The bank should review documentation that supports how controls operate, the testing process, and the reporting and timely remediation of any deficiencies. The bank should also review the Summary of Aggregate Deficiencies (SAD) report from its associations. The bank should ensure associations have timely and effective action plans to address reported weaknesses or deficiencies. Material weaknesses and significant deficiencies could potentially impact financial reporting at the bank and System level.

## Examination Procedures and Guidance

### Regulatory Compliance

#### **1. Eligibility & Scope of Financing:**

Evaluate the adequacy of guidance and controls to ensure compliance with eligibility and scope of financing regulations.

Guidance:

*The guidance for this procedure is currently under development. In the interim, the following link provides related guidance that was contained in the old FCA Examination Manual: [FCA Examination Bulletin 2006-2 Lending Programs for Farmers' Other Credit Needs](#)*

#### **2. Lending Authorities & Territories:**

Evaluate the adequacy of guidance and controls to ensure compliance with lending authority and chartered territories regulations.

Guidance:

#### **3. Loan Purchases & Sales:**

Evaluate the adequacy of guidance and controls to ensure compliance with loan purchases and sales regulations.

Guidance:

## Examination Procedures and Guidance

### Administration of Specific Lending Programs

#### **1. Capital Markets:**

Evaluate the adequacy of guidance and controls for administering capital markets lending programs.

Guidance:

#### **2. Scorecard Lending:**

Evaluate the adequacy of guidance and controls for administering scorecard lending programs.

Guidance:

*The guidance for this procedure is currently under development. In the interim, the following link provides related guidance that was contained in the old FCA Examination Manual: [EM-312 Scorecard Lending](#)*