



**EM-22.6**

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**Overview**

The *Collateral Risk Management* topic provides guidance on evaluating an institution's processes to identify, control, and report collateral risk and conduct collateral evaluations. Collateral risk management is a key loan portfolio management component, as volatility in the agricultural economy and changing conditions in the general economy can cause collateral values to change rapidly. Collateral risk exists in different forms and comes from many sources but is essentially the risk that collateral securing a loan will (1) decline in value after loan inception and (2) be insufficient to liquidate the loan, if necessary. Inaccurate collateral appraisals or evaluations, illiquidity or obsolescence on highly improved and specialized property, weakening economic and industry conditions, inappropriate loan advance rates or repayment terms, and many other factors can contribute to collateral risk exposure. Collateral risk exists in both real estate and chattel collateral. Guidance for this topic applies to banks, associations, and service corporations that engage in lending or leasing activities.

Management of collateral risk must occur at both the loan and portfolio levels. Effective collateral risk management requires the institution to establish systems and processes that collectively work to identify, control, and report collateral risk. On individual loans, the institution may take some or all of the following actions to manage and control collateral risk:

- Establish systems and processes that produce accurate, timely, and reliable collateral appraisals and valuations.
- Adhere to reasonable collateral standards or advance rates.
- Justify exceptions to collateral standards through offsetting strengths.
- Set repayment terms and controls that are consistent with collateral risk levels and in balance with other credit factors.

At the portfolio level, the institution must have systems in place to identify, measure, report, and manage collateral risk. Efforts to control collateral risk should vary according to collateral risk levels, but key components may include the following:

- Sound collateral underwriting standards supported by a lending culture that appropriately controls exceptions to standards.
- Pricing premiums for loans with elevated collateral risk.

- Loan structures designed to address and control collateral risk.
- Lending caps that limit the amount of financing provided (e.g., a limit on dollars per acre financed).
- More strict underwriting practices and standards on loans with elevated collateral risk.
- Systems and processes that produce accurate, timely, and reliable collateral appraisals and valuations.

Data systems and reporting processes should exist to provide key institution stakeholders with information on the extent of collateral risk in the loan portfolio, what steps are employed to manage that risk, and the results of collateral risk management efforts.

Collateral risk will vary based on the nature of the institution's territory and portfolio. As such, some concepts, strategies, and questions outlined below will apply to certain institutions but not others. Examiners should focus on assessing whether collateral risk is appropriately identified and managed and recognize that differences in institutions may result in a range of practices used to satisfactorily identify and manage collateral risk.

In addition to FCA's [Loan Portfolio Management](#) publication and this Examination Manual guidance, the following additional criteria and resources exist:

- FCA Informational Memorandums:
  - [National Oversight Plan for Fiscal Year 2011](#) dated December 2, 2010
  - [Collateral Risk Management in Farm Credit System Institutions](#) dated June 17, 2010
  - [Collateral Evaluation Requirements and Frequently Asked Questions](#) dated April 21, 2008
- FCA Examination Bulletin [2009-2](#) on Guidance for Evaluating the Safety and Soundness of [Farm Credit System] FCS Real Estate Lending (focusing on land in transition)

## **Examination Procedures and Guidance**

### **Identifying, Controlling, & Reporting Collateral Risk**

#### ***1. Identifying & Analyzing Collateral Risk:***

Evaluate the adequacy of efforts to identify, quantify, and analyze collateral risk.

#### **Guidance:**

The first step the board and management should take when addressing collateral risk is defining what constitutes collateral risk for their institution. Collateral risk will vary based on the nature of the institution's territory and portfolio. For example, one institution may consider certain types of collateral specialized in nature, but for other institutions, the same collateral may be common to its territory and portfolio. After defining collateral risk, the institution should establish systems and processes to quantify and analyze the risk. Depending on the characteristics of the portfolio, this could require periodic analyses or more significant special studies to evaluate collateral risk exposure. FCA's Informational Memorandums on the [National Oversight Plan for Fiscal Year 2011](#)

dated December 2, 2010, and [Collateral Risk Management in Farm Credit System Institutions](#) dated June 17, 2010, provide additional guidance.

Evaluative questions and items to consider when examining efforts to identify, quantify, and analyze collateral risk include:

- **Collateral Risk: Has the institution defined and identified what constitutes collateral risk for its portfolio?** The board and management should understand and define what they consider collateral risk within the portfolio. Processes and systems need to identify items that may contribute to collateral risk exposure. Some elements that could increase collateral risk exposure include the following:
  - *Specialized Collateral and Highly Improved Properties* – Collateral would typically be considered specialized if it is not common to the institution’s territory or portfolio. At times, an institution may not consider highly improved properties (e.g., livestock facilities, greenhouses, processing plants, expensive homes) specialized because these properties are common in the territory or portfolio. While this may be a reasonable assertion, highly improved properties still pose substantial collateral risk as they are highly depreciable and susceptible to functional obsolescence. As such, these properties should bear heightened scrutiny in the institution’s collateral risk management efforts.
  - *Industry Specific Characteristics* – Collateral may be highly susceptible to economic conditions in certain industries. For example, nurseries, greenhouses, land in transition, and timber or lumber operations are closely tied to the housing industry. Collateral may also have unique characteristics or factors that influence the collateral value or marketability. This could include things like permitting, water availability, and water rights. See FCA Examination Bulletin [2009-2](#) for additional guidance on land in transition.
  - *High Value/Dollar Per Acre* – Collateral risk can increase when financing real estate purchased or valued at levels greatly exceeding the value of typical agricultural properties in the territory.
  - *Limited Income-Producing Capacity* – Land in transition, followed by recreational property, are prominent examples of property types that typically have limited actual income-producing capacity in its current use. In some cases, pasture and grazing land could also fall into this category. Refer to FCA Examination Bulletin [2009-2](#) for additional information and criteria.
  - *Debt Service Capacity* – Elevated collateral risk may exist when a property’s income-producing potential does not fully support the property value or level of financing provided. This is common for most agricultural property. In addition, in some cases the nature of the real estate market is such that property is not purchased for its income-producing potential. As a result, institutions may not emphasize debt coverage and income capitalization concepts discussed below when differentiating collateral risk levels between transactions. Even though these types of real estate markets may be common, the property’s lack of income-producing capacity creates elevated collateral risk. This scenario has become more common but identifying this situation remains valuable and may include the following:

- Identify properties (and the volume secured by those properties) where the capitalization rates used to calculate the income approach-to-value were extremely low. What constitutes a low capitalization rate is best defined by the institution and its understanding of the income, expenses, and average capitalization rates of the similar assets. A common consideration involves a comparison of capitalization rate to a Treasury bill rate.
    - Utilize a debt coverage approach to identify properties (and the loan volume secured by those properties) where net returns generated by the real estate do not support the required debt service on the property. Realistic, long-term rental rates or returns to the owner or operator should be used as well as utilizing realistic interest rate assumptions for debt service calculations. Debt coverage ratios less than one indicate the expected income from the land cannot service the debt, thereby evidencing elevated collateral risk.
  - *Unique Lending Terms or Structure* – This would include loans with relatively long amortization (e.g., more than 20 years amortization from the current date). If the institution utilizes balloon structures, it is appropriate to identify this loan volume as having a relatively long amortization. The institution could choose to segment loan volume with long amortizations into two categories: (1) those with earlier balloon features and (2) those with a maturity that matches the amortization. Another consideration for increased collateral risk is if a real estate loan has a revolving feature, as potentially no principal repayment will occur while the revolving commitment is available.
  - *Collateral Securing Loans in Distressed Industries* – When an industry experiences adverse economic conditions, the collateral securing those loans typically declines in value and/or has decreased marketability. It is important for institutions to conduct updated collateral evaluations to ensure accurate and current collateral value and risk exposure. Institutions should closely monitor collateral positions, especially if collateral is vulnerable to economic downturns, to ensure the valuation methods account for market conditions and industry-specific risks.
- **Exposure: Has the institution identified how much loan volume is secured by collateral with increased risk?** Once collateral risk is identified, processes and systems should be in place to quantify the level of risk. The institution should consider if it has elevated collateral risk in any types of collateral risk, including those discussed above, which should be quantified.
- **Commercial and Short-Term Portfolio: Has the institution adequately identified and quantified collateral risk in its commercial and short-term loan portfolio?** Collateral risk management efforts are most often associated with real estate and mortgage loans, but collateral risk is also present in commercial loan portfolios. Collateral risk can be more difficult to assess on short-term loans because database systems may not capture sufficient collateral information. Institutions can use various systems to identify and monitor chattel values, sales activity, and trends in value (e.g., tracking results from machinery and livestock auctions, using blue book and machinery guide values, monitoring bid prices from local packing plants and grain terminals). To identify and quantify collateral risk in its commercial and short-term portfolio, the institution should analyze the following items:

- Loan volume where the borrower is not meeting borrowing base requirements.
  - Amount and volume of unsecured or undersecured loan commitments.
  - Loan volume secured by specialized crops or specialized chattel equipment.
  - Amount of crop operating loans where the borrower does not carry crop insurance.
  - Amount and volume of loans secured by chattel property where the industry is currently distressed.
  - Amount of fully advanced lines of credits where the borrower has not revolved the debt for an extended period.
- **Additional Studies and Analyses: Does the institution conduct additional studies and analyses to monitor collateral risk when needed?** It is a sound business practice to monitor land values and perform land value studies to identify trends in real estate values throughout the lending territory. These studies or analyses may coincide with semi-annual or annual appraisal updates to properties in the institution's benchmark appraisal system. Additionally analyses that stratify loan-to-value (LTV) ratios by age of the loan can provide additional insight into collateral risk. By stratifying LTV ratios by age of the loan, a more realistic collateral risk picture emerges versus simply reporting an LTV ratio for the entire portfolio since well-secured, older mortgage loans will have a lower LTV. To effectively evaluate these analyses, examiners should also be cognizant if the LTVs being monitored and reported are based on values from when the loan was originated, an updated or more recent collateral evaluation, or some other automated means, such as the institution's benchmark systems. The source and age of the values will influence conclusions drawn from the reports. Lastly, if the institution uses an automated collateral evaluation system, it could assess the relationship of how much loan volume is secured by property where appraisals were completed by automated systems versus traditional evaluation methods and any possible collateral risk due to the valuation approach used.
- **Further Segmentation and Analyses: On loan volume identified as having elevated collateral risk levels as discussed previously, has the institution further segmented and analyzed risk as needed?** Additional segmentation and analyses will help the institution determine what actions may be needed to manage the risk. The following factors should be considered in this analysis:
    - Probability of Default (PD) and Loss Given Default (LGD) ratings
    - LTV ratios
    - Age of collateral evaluations
    - Age or seasoning of loans
    - Length of loan amortization (at inception and years remaining at present)
    - Historic repayment performance
    - Borrower credit factors
    - Presence of federal guarantees or Federal Agricultural Mortgage Corporation (Farmer Mac) standby commitments
    - Use of long-term fixed interest rates to lessen threats to repayment capacity
    - Interest rate spreads (e.g., if elevated collateral risk is present, is the institution receiving a higher return as compensation)
- **Stress Testing: Has the institution completed stress testing to identify the impact of changes in collateral values on the portfolio?** The institution should assess potential shocks to collateral values as part of stress testing activities. Shocks to collateral values can either be generic in nature or tailored to address unique risks in select portfolio segments, specific

industries, or collateral types. The institution should consider shocks to land values caused by a rise in interest rates or rise in capitalization rates. Stress test scenarios should be designed to capture the significant threats to collateral values (severe yet plausible) and adjusted when warranted to reflect changes in the operating environment. The institution should base scenarios on documented and supported underlying assumptions. Stress tests and shocks should be commensurate with the complexity, size, and scope of the institution's operations. For additional information, see FCA's Informational Memorandum on [Stress testing expectations](#) dated September 8, 2023. *Note: Examiners completing this procedure should focus on the specific stress testing activity; the overall stress testing framework is examined using the Stress Testing Framework procedure in the Direction & Control of Operations Examination Manual topic.*

## **2. Collateral Data:**

Determine if data systems have sufficient capabilities to facilitate collateral risk analysis and management efforts.

### Guidance:

Effective collateral risk identification, analysis, and reporting depend on adequate collateral-related database information. Loan databases should include data fields and features to assist in identifying and analyzing collateral risk. As part of collateral risk analysis, many institutions use appraisal benchmarking systems to identify changes in collateral values and LTVs when bare land real estate collateral is involved. When appropriate, real estate collateral is mapped or linked to benchmark farms in the institution's territory. Based on changes in the benchmark properties value, the benchmarking system provides updated or estimated collateral values for many loans in the portfolio. Other institutions use an indexing process to adjust estimated market values based on regional land value information. While these processes are not generally used for new money lending decisions, they can assist in recognizing risk caused by changing real estate values.

Evaluative questions and items to consider when examining collateral-related data systems include:

- **Loan Database Systems: Are loan database systems equipped to readily identify and quantify collateral-related data?** Loan database systems need to be sufficient to capture key collateral-related data. Specifically, systems should help identify the following:
  - Date of the most recent collateral evaluation (i.e., appraisal, valuation, chattel evaluation).
  - Type and contributory value of improvements and contributory value of bare land.
  - Information on the property's income-producing capacity (e.g., debt coverage ratios, annual net income-producing capacity of the property on a total or per acre basis, capitalization rates on properties held).
  - When additional security exists in the form of a second lien position on another property or cross collateralization with another loan.
  - Features or data fields to identify when specialized collateral is securing the loan.
- **Data Accuracy: Does the institution have adequate processes and controls in place to ensure that collateral-related data is accurate?** Processes and systems should be in place to ensure collateral-related data is available and accurate in the loan database and internal

systems used in the benchmarking processes, as applicable. The institution should enter collateral-related data as part of the collateral evaluation or loan origination process; checklists can be used to help in the process. Examiners should consider internal credit review reports, appraisal and valuation reviews, management reviews, and transaction testing results, as appropriate, to evaluate adequacy of the processes and controls in data integrity.

- **Benchmarking: Does the institution use a benchmarking process, or an alternate system, in its collateral evaluation systems to provide updated collateral values for applicable loans and track land value trends in its territory?** Benchmarking or indexing of collateral values to collateral value trends within the territory or region can be an effective process to monitor real-time collateral positions of individual loans and the portfolio as a whole. At origination of a loan, the institution will tie the collateral securing that loan to a specific benchmark farm, which will be appraised periodically (typically annually), and changes in value of the benchmark farm will be used to adjust the estimated value of the subject collateral. When using indexing processes, the institution indexes collateral to a specific region at origination, and as values are reported to move higher or lower (via sales data or surveys), it automatically estimates collateral values based on those changes. If the institution has a benchmarking or indexing process, the following are sound business practices to consider:
  - Utilize a sufficient number of benchmark or indexed properties to capture the variety of land and property within the territory.
  - Determine what percentage of the portfolio and loan volume is linked to a benchmark or indexed.
  - Appraise benchmark properties or update indexed values with sufficient frequency (typically semi-annually, although annual may be sufficient in times of stable values) to facilitate timely identification of trends in property values.
  - Validate the accuracy of the benchmarking system. Process should be in place to ensure properties are tied to the correct benchmarks and values are properly updated with changes in benchmark values.

### **3. Collateral Underwriting Standards & Practices:**

Determine if collateral-related underwriting standards and other related practices are used effectively to identify and manage collateral risk.

#### Guidance:

Sound underwriting standards for the collateral credit factor combined with the discipline to seldom deviate from the standards provide institutions a key foundation for controlling collateral risk. To be effective, LTV standards or advance rates must be at levels where significant downward pressure on values can occur before the loan balance would exceed the collateral's underlying value. It is common to establish different underwriting standards based on loan or collateral type. Additionally, exceptions to collateral underwriting standards should be appropriately managed and reported to the board.

Evaluative questions and items to consider when examining collateral underwriting standards include:

- ***Underwriting Standards: Are there appropriate collateral underwriting standards for specific industries, loan programs, and portfolio segments that provide a reasonable margin of protection against loan losses?*** It is a sound business practice for the institution to develop different collateral underwriting standards for specific industries, loan programs, and portfolio segments. For example, it may be prudent to set an LTV standard at 65 percent or lower on bare land. Collateral underwriting standards should be at levels where borrowers continue to have equity in the collateral in the event values decline markedly. Collateral underwriting standards and related guidance for loans and industries that typically have elevated collateral risk (see the *Identifying & Analyzing Collateral Risk* procedure for examples) can require greater working capital, net worth, and repayment capacity compared to loans and industries with lower collateral risk. Additionally, collateral underwriting standards should be more conservative when loans are secured by items such as highly improved properties, specialized collateral, and properties with limited income-producing potential. As the property value further exceeds the income-producing potential of the property, collateral underwriting standards should become increasingly conservative. Collateral underwriting standards approaching the regulatory maximum of 85 percent LTV on mortgage loans warrant extensive scrutiny. Oftentimes it is a sound business practice to establish different collateral underwriting standards for commercial and short-term loans. On loans where collateral risk is elevated, the institution can use other underwriting practices and standards to partially mitigate the risk by requiring greater working capital, net worth, and repayment capacity. Finally, when concluding on the adequacy of specific collateral underwriting standards, consider the relative soundness of accompanying standards for the other credit factors and the adequacy of the institution's overall underwriting process. Refer to the *Loan Underwriting Direction* Examination Manual topic for additional guidance. Lastly, standards should be reevaluated and adjusted, as appropriate, in response to changing market conditions.
- ***Unique Standards & Guidance: Do collateral underwriting standards and related underwriting guidance address specialized collateral, livestock facilities, and financing down payments with other loans?*** The following outlines considerations for unique standards and guidance:
  - *Specialized Collateral* – Collateral underwriting standards should address unique risk factors (e.g., specialized collateral, timber tracts, property with limited or no income-producing capabilities). Underwriting standards should be increasingly conservative as collateral risk increases. Additionally, LTV requirements in underwriting standards should be more conservative when security consists of property with limited current income-producing capacity compared to property that provides a reasonable income stream. As noted in FCA Examination Bulletin [2009-2](#), other financial regulatory agencies have set 65 percent as the maximum LTV standard on raw land, which would include land in transition, recreational property, and other property with limited or no current income-producing capacity.
  - *Livestock Facilities* – Collateral underwriting standards should consider the need for ensuring operations have an adequate amount of land under their control to meet regulatory requirements for manure disposal. The institution's collateral perfection

process could include taking easements on land utilized by livestock borrowers for manure disposal that are transferrable to the institution in the event of legal collection.

- *Financing Down Payments* – Collateral underwriting guidance should address whether, and under what circumstances, the institution will allow borrowers to finance down payments on land purchases with short-term loans or via borrowing against other real estate. The appropriateness of this approach depends heavily on the borrower’s overall financial position and capacity. Situations where the borrower finances the down payment with short-term loans warrant particular scrutiny, especially if the institution used short-term funding because the borrower was unable to provide or borrow against additional real estate collateral.
- **Exceptions: Are exceptions to collateral underwriting standards managed appropriately?** Exceptions to collateral underwriting standards should be adequately tracked, analyzed, and justified by offsetting strengths. While exceptions to underwriting standards will occur, exceptions to collateral underwriting standards should be relatively infrequent. Institutions should fully document, support, and approve exceptions. Sometimes collateral exceptions require Loan Committee approval, or they can be approved within delegated authority levels. Institutions should fully document and support this delegated authority. Collateral exception reporting information will identify if there are trends in exceptions. Exception levels should be viewed in the context of the appropriateness of established collateral underwriting standards. For example, an institution with a 5 percent exception rate and an LTV standard of 65 percent is likely taking significantly less risk than an institution that has no collateral exceptions but has an LTV standard of 75 percent.

#### **4. Other Collateral Risk Management Tools:**

Determine if the institution is effectively using other tools, such as loan pricing, loan structure, and lending caps, to manage collateral risk.

##### Guidance:

Other tools exist to aid in collateral risk management efforts. Loan pricing premiums are a viable option to compensate for increased collateral risk. Pricing premiums can influence a borrower’s willingness to pledge additional collateral, provide greater down payments, and choose shorter amortization periods, all of which reduce collateral risk. The institution can also manage collateral risk through loan structure and terms. For example, shorter loan amortizations and payment schedules that require a set amount of principal each year reduce collateral risk over shorter periods of time. Additionally, the institution can use lending caps to set limits on the amount of financing provided on real estate transactions. The institution’s policies and procedures should address guidance for using each of these tools.

Evaluative questions and items to consider when examining collateral risk management tools include:

- **Loan Pricing: Does the institution effectively manage collateral risk through loan pricing practices when needed?** Loan pricing can be an effective way to manage collateral risk. Examples include charging a premium for loans with exceptions to collateral underwriting standards, longer amortizations, specialized collateral, or property with limited income-producing potential. Also, an institution may use a scoring system to determine the interest rate that a borrower qualifies for, and LTV levels or other collateral factors may be

contributors to the pricing score. On loans where the institution identifies elevated collateral risk (as discussed in the *Identifying & Analyzing Collateral Risk* procedure), determine if interest rate spreads evidence the institution is compensated for higher collateral risk levels. Refer to the *Loan Pricing & Structuring* procedures in the *Earnings Management* Examination Manual topic for additional guidance.

- **Loan Terms & Conditions: Does the institution effectively manage collateral risk through reduced loan amortization, accelerated loan repayment terms, and other terms and conditions when needed?** If the institution uses these tools, credit guidance should include direction to staff on using loan structure, loan amortizations, and terms and conditions to manage collateral risk. Loan actions, underwriting reports, and other board materials could be used to assess if loans with elevated collateral risk levels have more conservative terms and conditions. In general, as collateral risk increases, the institution should use more conservative repayment structures. Refer to the *Credit Administration Guidance & Standards* procedures in the *Credit Administration* Examination Manual topic for additional guidance on loan terms and conditions. However, the following provides additional guidance specific to managing collateral risk:
  - *Amortizations* – Amortization on loans secured by specialized collateral and highly improved or rapidly depreciating properties should be relatively short. Also, on typical agricultural real estate loans (i.e., secured by bare land), amortizations of 20 years or less can help manage collateral risk. A large amount of recently underwritten real estate loan volume with amortizations of more than 20 years would warrant additional review, particularly when other risk factors are present (e.g., collateral underwriting exceptions, relatively high LTV ratios [above 65 percent], or the secured property has limited current income-producing potential). Institutions can use LTV levels to guide the length of loan amortizations that are offered to the customer (e.g., as LTVs increase, shorter loan amortizations are utilized).
  - *Non-Amortizations* – Absent mitigating factors, the presence of non-amortizing structures (e.g., multiple years of interest-only payments, payment reserves funded by the lender) on loans with elevated collateral risk should be viewed as a significant risk. Mitigating factors could include items such as the non-amortizing loan is controlled via a well-structured borrowing base arrangement involving appropriate collateral or is part of a construction financing package where the debt will begin amortizing once construction is complete.
  - *Level Principal Payment* – Level principal payment loan structures can be useful in managing collateral risk. A level payment structure results in more rapid principal reduction in the initial years of the loan compared to level payments.
- **Lending Caps: Does the institution utilize lending caps to effectively manage collateral risk when needed?** Typically, under a cap system the institution would set a limit on the dollars per acre it would finance (e.g., maximum debt of \$6,000 per tillable acre regardless of purchase price being \$12,000 per tillable acre). Oftentimes, in highly competitive real estate markets, the resulting LTV ratios under a lending cap are lower than what would be allowed by an LTV standard (e.g., the resulting LTV for the above scenario would be 50 percent and the LTV standard may be 65 percent). If the institution utilizes lending caps, the following are sound business practices to consider:

- Utilize reasonable and well-supported methodology to calculate and set the caps. For example, when establishing lending caps, consider the long-term, sustainable, income-producing capacity of the real estate collateral.
- Review current land sales and values in the territory in establishing lending caps.
- Establish different caps to account for geographic or regional differences in the institution's territory.
- Set the caps at levels that constructively influence lending decisions. Setting the caps at relatively high levels could result in the caps having little influence on lending activity.
- Evaluate if lending cap levels are reasonable compared to the institution's LTV collateral underwriting standards.
- Limit exceptions to the caps and document the justification for exceptions.

### **5. Board Reporting:**

Determine if reporting processes are sufficient to facilitate effective collateral risk management.

#### Guidance:

Reporting should address collateral risk levels as well as the impact collateral risk exposure has on the institution's overall risk profile. Reporting should identify the success of risk management efforts and facilitate development of new risk management strategies.

Evaluative questions and items to consider when examining board reporting on collateral risk include:

- **Content: Do collateral risk-related reports adequately address significant sources of collateral risk and quantify collateral risk exposure?** Board reports should provide enough information for the board to understand where elevated collateral risk resides in the institution's portfolio and the extent of the exposure. Refer to the *Identifying & Analyzing Collateral Risk* procedure for guidance on collateral risk exposure. Board reports should also provide information on collateral risk management efforts and the results of those efforts, including those discussed in the *Collateral Underwriting Standards & Practices* and *Other Collateral Risk Management Tools* procedures. Lastly, the board should receive reports showing exceptions to collateral underwriting standards and other risk measures (e.g., lending caps, loan terms and conditions, loan pricing) and identify emerging trends in collateral values and underwriting exceptions. Management may include reporting on these areas within other board reports or in a standalone collateral risk report.
- **Frequency: Are collateral risk-related reports provided to the board at least annually?** Management should report to the board or designated board committee on collateral risk levels and related management actions at least annually and more often as warranted by conditions.

## Examination Procedures and Guidance

### Collateral Evaluation Practices & Controls

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

Determine if collateral-related guidance effectively communicates to staff the necessary direction and standards to administer collateral evaluation, verification, and monitoring functions in a safe and sound manner and in compliance with FCA regulations.

#### Guidance:

Collateral evaluation guidance should communicate how to perform and document key aspects of the appraisal and valuation process in compliance with FCA regulations. Guidance should clearly define management expectations in areas such as collateral inspections, when to update appraisals and valuations, and using outside appraisers. Collateral evaluation guidance should be adequate and reasonable in terms of content, criteria, parameters, expectations, etc. The goal is to ensure that guidance and direction will result in accurate and reliable collateral values to support loan decisions, risk identification, and collateral risk management efforts.

FCA Regulation [614.4240](#) includes various collateral definitions that are useful when examining collateral evaluation guidance and standards. FCA's [FAQs About Collateral Evaluations](#) and FCA's Informational Memorandums on [Collateral Risk Management in Farm Credit System Institutions](#) dated June 17, 2010, and [Collateral Evaluation Requirements and Frequently Asked Questions](#) dated April 21, 2008, provide additional guidance. Also, the [Interagency Appraisal and Evaluation Guidelines](#) published by several other federal financial regulatory agencies includes additional background information when evaluating safety and soundness of collateral evaluation practices.

Evaluative questions and items to consider when examining collateral policies, procedures, standards, and other guidance include:

- **Policy & Standards: Do board policies and standards related to collateral evaluations comply with FCA regulations?** FCA Regulation [614.4245](#) requires the board of each institution that engages in lending or leasing secured by collateral to adopt well-defined and effective collateral evaluation policies and standards. The policies and standards must address the following requirements:
  - Collateral evaluations must be:
    - Sufficiently descriptive and detailed to provide ample support to the institution's related credit decisions.
    - Performed based on criteria specifying when and what type of collateral evaluation is required. Such criteria must, at a minimum, establish when an institution will require a collateral appraisal completed under the Uniform Standards of Professional Appraisal Practices (USPAP) rather than a collateral valuation; and take into account such factors as market trends, market volatility, and various types of credit, loan servicing, collection, and liquidation actions.
    - Completed by a qualified evaluator in an unbiased manner.

- Address, at a minimum, the criteria outlined in FCA Regulations [614.4250 – 614.4267](#). Use the *Collateral Evaluation Requirements* workpaper (see Part 3 of the Examination Manual) to examine compliance with the following regulations:
  - *FCA Regulation [614.4250](#)* – Requires that collateral evaluations be performed in accordance with FCA Regulation [614.4260](#) and the institution’s policies and procedures. Collateral evaluations of real, personal, or intangible property taken as security for a loan or subject of a lease must be identified as either a collateral valuation or collateral appraisal.
  - *FCA Regulation [614.4255](#)* – Outlines specific requirements and prohibitions related to independence of collateral evaluations.
  - *FCA Regulation [614.4260](#)* – Outlines specific requirements related to collateral evaluations.
  - *FCA Regulation [614.4265](#)* – Outlines specific requirements related to real property evaluations.
  - *FCA Regulation [614.4266](#)* – Outlines specific requirements related to personal and intangible property evaluations.
  - *FCA Regulation [614.4267](#)* – Outlines specific requirements related to professional association membership and competency.
- The board may adopt specific collateral evaluation requirements, consistent with the regulations in this subpart, for loans designated as part of a minimum information program.
- ***Additional Direction & Guidance for Real Property: Do board policies, procedures, and standards provide effective guidance related to appraisals and collateral valuations?*** While regulations require institutions to address specific elements in policy and standards as noted previously, the institution should consider the following sound business practices when providing additional direction and guidance to staff regarding appraisals and collateral valuations:
  - Expectation that appraisals and collateral valuations identify and support critical factors of market value, including, at a minimum, the following:
    - The contributory value of all improvements.
    - The highest and best use of the property.
    - Legal and physical access to the property.
    - Area and neighborhood characteristics that impact marketability of the property.
    - Descriptions of any easements or legal restrictions that could affect marketability of the property.
  - Requirements for when the property needs an environmental assessment.

- Criteria for the acceptable age of appraisals or valuations used in credit decisions and servicing actions and what events will require new appraisals or valuations. The institution may differentiate the criteria by the nature of the credit action, current LTV ratio, property characteristics (e.g., bare land versus improved property), and borrower risk profile.
- ***Additional Direction & Guidance for Chattel Evaluations: Do board policies, procedures, or standards provide effective guidance related to chattel evaluations?*** While regulations require the institution to address specific elements in policy and standards as noted previously, the institution should consider the following sound business practices when providing additional direction and guidance to staff regarding chattel evaluations:
  - Criteria for methods and approaches to valuing growing crops, crop inventory, market livestock, equipment, and other current assets held as collateral. This would also include criteria for valuing specialty collateral, discounting chattels, and assigning collateral values in distressed loan situations.
  - Expectations for when and how inspections are used as part of the chattel evaluation process. The primary purpose for any inspection is to verify the existence, followed by the condition, and other details of collateral. Guidance should address timing and frequency for conducting inspections, including any variation based on the risk profile of the loan and/or underlying collateral.
  - Processes to verify the ownership of collateral. This is particularly important for operations that commingle assets owned by different individuals (e.g., family members, partners) and complex accounts with liquid collateral held at multiple locations (e.g., cattle feeding operations, other large livestock operations, multi-location agribusinesses).
  - Expectations for documenting the description of farm equipment and its condition as well as verifying growing crops, crop inventory, and paper-reported collateral values (e.g., accounts receivable, warehouse receipts, cooperative retains).
  - Expectations for documenting when the same collateral is pledged on multiple loans to ensure appropriate cross-collateralization and liquidation order to ensure that collateral is not over-pledged.
  - Approved sources for determining chattel values (e.g., blue book values, auction results, local grain elevator prices, crop insurance coverage, local livestock auction markets).
  - Guidance on the use of borrowing bases for chattel and personal property. Borrowing bases can be complex due to varying processes used to value assets, determining if the types of assets included are appropriate for the loan purpose, and varying advance rates for the different asset types. Guidance should address when borrowing bases should be used, reporting frequency, verification and monitoring expectations, and how to structure and administer borrowing bases. Refer to the *Credit Administration Guidance & Standards* procedure in the *Credit Administration Examination Manual* topic for examining the institution's borrowing base guidance.

## 2. Business Loan Exemptions:

Determine if the institution has adequate controls and processes to ensure business loan appraisal exemptions are handled appropriately.

### Guidance:

FCA Regulation [614.4260\(c\)\(2\)](#) allows for an exemption to appraisal requirements for business loans under \$1 million that are not dependent on income derived from the sale or cash rental of real estate as the primary source of repayment. Refer to the regulation and FCA's Informational Memorandum on [Collateral Evaluation Requirements and Frequently Asked Questions](#) dated April 21, 2008, for an overview of specific regulatory requirements. *Attachment 1* of the Informational Memorandum provides a flow chart for determining when the business loan exemption applies, while *Attachment 2* provides representative examples of exemption criteria being applied.

Evaluative questions and items to consider when examining use of the business loan exemption include:

- ***Policies & Procedures:*** **If the institution utilizes the business loan appraisal exemption, is guidance and direction to staff adequate and consistent with regulatory requirements?** The business loan exemption allows qualified evaluators (e.g., lending staff potentially) to complete certain collateral evaluations rather than certified appraisers. Even though an appraisal is not required on business loans of \$1.0 million or less, institutions still must complete a valuation in accordance with requirements in FCA Regulations [614.4250](#), [614.4260](#), and [614.4265](#). Institutions should document guidance and direction to staff on exemption use that is consistent with regulatory requirements.
- ***Approvals:*** **Is business loan exemption use subject to prior approval or post review by management?** This is particularly important when a person making the credit decision is also completing the collateral evaluation (refer to FCA Regulation [614.4255\(b\)](#), which says the person making the credit decision is allowed to complete the collateral evaluation if the institution has internal control procedures required by FCA Regulation [618.8430](#) in place that include requirements for either a prior approval or post-review of credit decisions. (Note: such procedures do not need to require an approval or review of every evaluation).
- ***Monitoring:*** **Is business loan exemption use monitored or centrally tracked?** It is important that management understand the extent of use for this exemption to ensure staff use it appropriately. Management can perform spot checks, conduct second line reviews, and provide input on scoping audits and reviews to ensure continued compliance with FCA regulations.
- ***Qualified Evaluator:*** **When the business loan exemption is used, are valuations completed by a qualified evaluator and are controls in place to ensure the resulting valuations meet the regulatory requirements?** Qualified evaluators, as defined in FCA Regulation [614.4240\(n\)](#), must be used when the business loan exemption is used. Additionally, all valuations must comply with FCA Regulations [614.4250](#) and [614.4265](#).

### 3. Appraisers & Evaluators:

Evaluate the qualifications, training, and independence of appraisers and evaluators, including, outside fee appraisers and evaluators, and other non-institution staff in completing collateral evaluations.

#### Guidance:

A key component to collateral risk management is managing the qualifications, training, and independence of appraisers and evaluators, including outside fee appraisers (as defined in FCA Regulation [614.4240\(h\)](#)). Typically, institutions use various sources of appraisers and evaluators ranging from certified appraisers to institution employees. It is important that the institution establish clear expectations and guidance around who will conduct appraisals and collateral evaluations (including chattel evaluations). Additionally, appraisers and evaluators need to be qualified, trained, and independent, as discussed below.

Evaluative questions and items to consider when examining appraisers and evaluators include:

- **Appraiser and Evaluator Staffing: Is the approach to staffing the appraisal and collateral evaluation function appropriate for the institution?** The board and management should consider factors such as the nature of the territory along with the size, complexity, and risk profile of the institution, when determining the best staffing approach. As the size and complexity of the institution grows, the board and management should reevaluate the needs of the appraisal and collateral evaluation function to ensure it remains effective and adequately staffed to carry out its responsibilities. The primary approaches to staffing this function include in-house, outsourcing, and some combination of the two (i.e., co-sourcing). Co-sourcing engagements are typically overseen by the appraisal and collateral evaluation department staff. Each approach has advantages and disadvantages that management should consider when determining the most appropriate appraisal and collateral evaluation staffing structure.
- **Competencies: Do appraisers and evaluators have the necessary skills and competencies to perform their duties?** Appraisers and evaluators, whether in-house or outsourced, need to possess the necessary skills and competencies to perform their duties. FCA Regulations [614.4240\(n\)](#), [\(s\)](#), and [\(t\)](#) define qualified evaluator, State-certified appraiser, and State-licensed appraiser, respectively. FCA Regulation [614.4267\(b\)](#) requires all staff and fee evaluators, including appraisers, performing evaluations in connection with real, personal, or intangible property taken as collateral in connection with extensions of credit, to meet the qualification requirements in FCA Regulations [Part 614 Subpart F](#). However, an evaluator (as defined in FCA Regulation [614.4240\(n\)](#)) may not be considered competent solely by virtue of being certified, licensed, or accredited. A determination of competency shall be based on the individual's experience and educational background as they relate to the particular evaluation assignment for which the individual is being considered. Additionally, appraisers and evaluators should maintain their skills through continuing professional development. The board and management should define minimum and desired qualifications for appraisers and evaluators, including outside fee appraisers and evaluators. It is a sound business practice to have an approval process for outside appraisers and evaluators. The process should include a review of a sample of their appraisals or evaluations. If review results are satisfactory, the person may be added to the approved list

of outside appraisers and evaluators. Examiners can evaluate appraiser and evaluator competencies by reviewing items such as the following:

- Resumes, including educational background, work experience, and involvement in professional organizations.
  - Certifications, (i.e., State certifications or licenses), and professional accreditations (i.e., accredited rural appraiser or member), appraisal institute designations. Note: FCA Regulation [614.4267\(a\)](#) prohibits the institution from excluding a certified appraiser from consideration for an assignment solely by virtue of membership or lack of membership in any particular appraisal organization.
  - Commitment to continuing education through participation in courses sponsored by industry groups or through in-house training programs.
  - Job descriptions and performance evaluations.
  - The quality of work performed and the ability to effectively communicate the results of that work.
- ***Independence and Objectivity: Does the board and management ensure the independence and objectivity of appraisers and evaluators?*** FCA Regulation [614.4255](#) includes specific independence requirements and restrictions, which are listed below. The institution needs to have adequate controls in place to ensure compliance with these regulatory requirements and restrictions.
    - *Prohibitions (FCA Regulation [614.4255\(a\)](#))* – For all personal and intangible property, and for all real property exempted under FCA Regulation [614.4260\(c\)](#), no person may:
      - Perform evaluations in connection with transactions in which they have a direct or indirect interest, financial or otherwise, in the loan or subject property.
      - As a director, vote on or approve a loan decision on which they performed a collateral evaluation.
      - As a director, perform a collateral evaluation in connection with any transaction on which they made or will be required to make a credit decision.
    - *Officers and Employees (FCA Regulation [614.4255\(b\)](#))* – If the institution’s internal control procedures include requirements for either a prior approval or post-review of credit decisions, officers and employees may:
      - Participate in a vote or approval involving assets on which they performed a collateral evaluation.
      - Perform a collateral evaluation in connection with a transaction on which they have made or will be required to make a credit decision.
    - *Real Estate Appraiser (FCA Regulation [614.4255\(c\)](#))* – Except as outlined in FCA Regulation [614.4260\(c\)](#), all evaluations of real property that serve as the primary

security for a loan shall be performed by a qualified real estate appraiser who has no direct or indirect interest, financial or otherwise, in the loan or subject property and is not engaged in the marketing, lending, collection, or credit decision processes of any of the following:

- A Farm Credit System (System) institution making or originating the loan.
- A System institution operating under common management with the institution making or originating the loan.
- A System institution purchasing an interest in the loan.
- *Fee Appraisers (FCA Regulation [614.4255\(d\)](#))* – Fee appraisers shall be engaged directly by the institution or its agent, and shall have no direct or indirect interest, financial or otherwise, in the property or transaction. The institution may accept a real estate appraisal that was prepared by an appraiser engaged directly by another System institution, by a U.S. Government agency, a Government-Sponsored Enterprise or by a financial institution subject to title XI of FIRREA.
- *Loan Purchases (FCA Regulation [614.4255\(e\)](#))* – No employee who, acting as a State-licensed or State-certified appraiser, performed a real estate appraisal on any collateral supporting a loan shall subsequently participate in any decision related to the loan purchase.
- ***Outsourcing: Does the institution adequately manage its outsourced (external or fee) appraisal and collateral evaluation resources?*** The institution may contract appraisal and collateral evaluation work with outside professionals to gain operational efficiencies or expertise. For example, the institution may use outsourcing when the internal staff members lack the expertise needed in specialized areas or when internal resources are insufficient. However, the institution needs to actively oversee outsourced activities. Refer to the *Third-Party Risk Management* procedure in the *Direction & Control of Operations* Examination Manual topic for information on examining an institution’s outsourcing processes. The following are additional considerations when evaluating appraisal and collateral evaluation outsourcing:
  - Due to the nature of outsourcing, the institution should perform sufficient due diligence to verify fee appraiser qualifications before entering the outsourcing arrangement. This includes reviewing resume(s) and verifying state certification and licensing requirements.
  - Institutions should have controls and processes to facilitate independence between the credit and appraisal functions. Specifically, loan officers should not have the ability to directly engage a fee appraiser. Instead, the institution should randomly assign appraisal assignments to a fee appraiser on the institution’s approved appraiser list, or the fee appraiser should be selected by the institution’s collateral manager (or similar position).
  - Engagement contracts should be in place prior to starting the assigned work. Management (and sometimes the board) should review and approve engagement contracts and discuss the terms with the party being engaged, as needed. Items that should typically be addressed in an engagement contract include:

- Details on the scope of work.
- Time period and other engagement terms consistent with the established scope.
- Details on who will perform the activities (if different from the original proposal) and their qualifications.
- The framework, principles, or body of standards under which the appraisal or collateral evaluations is completed (e.g., USPAP).
- Documentation expectations for appraisals and collateral evaluations.
- Defined lines of communications between the institution and the engaged party.

#### **4. Automated Collateral Evaluation Systems:**

Conclude on the adequacy of any automated collateral evaluation systems used by the institution.

##### Guidance:

Some institutions utilize automated collateral evaluation systems to assign collateral values on certain properties. When using automated systems, the institution needs to ensure sufficient data is available to statistically determine accurate collateral values. Institutions generally utilize automated systems to value non-complex, homogenous collateral types typical to the territory when low credit risk exists. Use of such systems is addressed in FCA's Informational Memorandum on [Collateral Evaluation Requirements and Frequently Asked Questions](#) dated April 21, 2008.

Evaluative questions and items to consider when examining automated collateral evaluation systems include:

- **Policy and Procedures: If the institution uses an automated collateral evaluation system, are effective policy and procedures in place governing the system and processes?** The institution should document guidance to direct system use, including key controls, processes, and methodologies. It is a sound business practice to limit the use of automated systems to properties that are homogenous, common to the territory, and with limited or no improvements. Additionally, there should be enough underlying sales or valuation data to statistically determine accurate collateral values. Resulting appraisals and valuations must comply with applicable professional and regulatory standards. Appraisals completed under automated systems must still meet USPAP standards and be signed by a State-licensed or certified appraiser. Also, if the institution uses automated systems to complete valuations under the business loan exemption, those valuations must meet applicable regulatory requirements as discussed in the *Business Loan Exemptions* procedure.
- **Models: Are models used for appraisals and valuations managed in accordance with the institution's model risk management (MRM) framework and the guidance outlined in FCA's Model Risk Management procedure in the Direction & Control of Operations Examination Manual topic?** These models should be included in the institution's model inventory, which should accurately represent each model's risk, materiality, and validation status. Model validation, change controls, staffing, separation of duties, and new model development should be consistent with the guidance in the institution's MRM framework and FCA's *Model Risk Management* procedure, recognizing that application of this guidance

varies based on model risk and materiality. *Note: Examiners completing this procedure should focus on the specific model(s) being used; the overall MRM framework is examined using the Model Risk Management procedure referenced above.*

## Examination Procedures and Guidance

### General

#### **1. Audit/Review:**

Determine if the institution conducts an effective audit or review of collateral risk management and collateral evaluation processes.

#### Guidance:

FCA Regulation [618.8430](#) requires institutions to have an internal control policy that addresses standards for assessing the appraisal of collateral as part of the institution's program to review and assess its assets. Institutions must also have appropriate review systems in place to ensure the integrity of collateral evaluations and the related guidance and processes. Refer to the *Internal Control Policy* procedure in the *Direction & Control of Operations* Examination Manual topic for examining internal control policy compliance. An independent evaluator or internal audit can complete collateral evaluation reviews. Regardless, the audit or review process needs to be clearly planned, documented, and reported. FCA's Informational Memorandums on [Collateral Risk Management in Farm Credit System Institutions](#) dated June 17, 2010, and [Collateral Evaluation Requirements and Frequently Asked Questions](#) dated April 21, 2008, provide additional guidance on collateral evaluation reviews. Examiners need to adapt the evaluative questions below based on the type of audit or collateral evaluation review being examined (e.g., internal operational audit of collateral risk management, internal credit review, independent collateral evaluation review).

Evaluative questions and items to consider when examining collateral evaluation audit and review processes include:

- ***Collateral Risk Management and Collateral Evaluation Audit or Review Coverage: Are collateral risk management and collateral evaluation audits or reviews conducted and documented as part of the institution's internal control or audit program?*** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Collateral evaluation review frequency should consider changes and trends in the real estate market. Coverage should also be consistent with the institution's risk assessment results and annual audit plan. While the institution can conduct collateral evaluation reviews outside of an internal audit program, collateral risk management is an auditable area that should be included in the risk assessment and audit plan.
- ***Scope and Depth: Are audit or review scope and depth sufficient to conclude on the adequacy, completeness, and timeliness of collateral risk management and collateral evaluation processes?*** The scope and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed and be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be documented and consistent with the approved audit or review plan and engagement contract (if applicable). Workpapers should be reviewed to verify the actual scope and depth of work performed. The workpapers may indicate the scope and depth deviated from what was

identified (or implied) in the audit or review plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and did not include reviewing other controls (e.g., training or reporting), or testing compliance with regulations or institution guidance. If the work deviated materially from the approved audit plan, internal audit staff should notify the board or Audit Committee of the reasons for the change. Specific items that should be considered in the audit or review scope include:

- Collateral risk management and collateral evaluation-related policies and procedures.
- Compliance with collateral risk management and collateral evaluation-related policies, procedures, FCA regulations, and other FCA guidance. This includes the following requirements related to evaluators who are not certified appraisers:
  - An evaluation of compliance with FCA Regulations [614.4265\(g\)](#) and [614.4266\(d\)](#), which require periodic collateral inspections by the institution's account officer or other designee when outside fee appraisers or evaluators are used.
  - An assessment of who qualifies as an evaluator based on the institution's policies and procedures and the requirements in FCA Regulations [Part 614 Subpart F](#).
  - Use of the business loan exemption as defined in FCA Regulation [614.4260\(c\)\(2\)](#), if applicable.
- Monitoring and control processes (e.g., reporting, management oversight, separation of duties, management information systems).
- Sufficient transaction testing to ensure accurate collateral values and compliance with FCA regulations and policies and procedures. A reasonable number of appraisals and collateral evaluations (including chattel evaluations and inspections) should be reviewed annually in light of the overall number of appraisals and evaluations performed. The audit or review sample should include work performed by all appraisers and evaluators, including outside fee appraisers, and different types of appraisal or collateral evaluations (e.g., valuations completed under the business loan exemption, chattel inspections).
- Management of all significant collateral evaluation models (e.g., automated collateral evaluation system), including consistency with the institution's overall model risk management framework.
- Fraud-related threats and vulnerabilities, as well as anti-fraud controls.
- **Reliability of Results: Did FCA identify any concerns with audit or collateral evaluation review reliability?** It is important to understand the scope and depth of the audit or collateral evaluation review being examined, as discussed above, when evaluating audit or review reliability. With this understanding, the following are key considerations when evaluating the reliability of audit or collateral evaluation review results:
  - *FCA Testing* – Evaluate the reliability of internal audit and collateral evaluation review work by comparing the results to FCA's examination results in this area. This

comparison often includes FCA testing transactions covered in the internal audit or collateral evaluation review (transactions are often appraisals or collateral evaluations, 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 internal audit staff (e.g., chief audit executive (CAE), audit coordinator) to obtain a more thorough understanding of work completed. This can be especially important if the audit or review report is insufficiently detailed or FCA's examination work and testing identified potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, forms, or other relevant audit documentation when conducting and supporting their work. (IIA Standards 13.6 and 14.6) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or collateral evaluation review, examiners should determine the cause for any discrepancy.

- *Audit/Review Staffing* – Whether internal or outsourced, auditors and reviewers conducting the work need to be qualified, independent, and objective to ensure reliable results. They should have the right mix of knowledge, experience, skills, and other competencies needed to perform the work (e.g., appraisal certifications or extensive appraisal or collateral valuation background for collateral evaluation reviewers). (IIA Standard 10.2 and 13.5) Additionally, auditors and reviewers need to be independent of the activities they audit so they can carry out their work freely and objectively. (IIA Standards 2.1, 2.2, 2.3, and 7.1) For example, auditors and reviewers should not be involved in developing and implementing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. A party independent of the person that completed the appraisal or evaluation must complete appraisal and collateral evaluation reviews. Examiners should evaluate staffing on the individual audit or review being examined as part of determining the reliability of results.
- *Institution Review of Work Performed* – The institution should complete an independent review of an adequate sample of the workpapers to ensure audit or review objectives and scope are met and the results and conclusions are reliable and supported. (IIA Standard 12.3 and 14.6) This could include the CAE or other audit staff (or collateral department staff in the case of collateral reviews) completing a review of in-house audit work or outsourced work. Examiners should consider whether the institution completed these reviews, and if any concerns were identified, when concluding on audit or review reliability.
- **Reports: Does the internal audit or collateral evaluation review report sufficiently communicate collateral risk management or collateral evaluation review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report (Note: not all items below would apply to a collateral evaluation review report):
  - Is the report prepared and communicated 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? (IIA Standards 11.2, 11.3, 13.1, 14.3, 14.5, 14.6, and 15.1)
- Are conclusions and recommendations reasonable, with material and higher-risk issues clearly identified and prioritized? (IIA Standards 14.3, 14.5, and 15.1)
- Are conclusions and recommendations supported by convincing evidence and persuasive arguments (condition, criteria, cause, and effect)? (IIA Standards 11.3, 13.4, 14.2, and 14.3)
- Do results in the workpapers align with report conclusions? (IIA Standard 14.6)
- 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? (IIA Standards 14.5 and 15.1)
- Does the report address potential vulnerabilities to fraud, if applicable?
- **Corrective Action: Are management responses to audit or collateral evaluation review findings in this area reasonable, complete, and timely? Were corrective actions 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 commitments and agreements or any areas of disagreement should be documented in the report, a separate memorandum, or a tracking system. (IIA Standards 11.5, 13.1, 14.4, 15.1, and 15.2) If corrective actions are not resolving the issues or concerns in a timely manner, examiners should further investigate the reasons. For example, this could indicate the audit or review insufficiently identified the underlying causes or materiality of weaknesses, sufficient resources were not being directed toward corrective actions, or weaknesses existed in the institution's corrective action process, including board oversight of the process.

## **2. Transaction Testing:**

Examine individual collateral appraisals and evaluations to assess compliance with collateral evaluation regulatory requirements and the institution's guidance and standards, and the reliability of collateral-related internal controls.

### Guidance:

FCA's transaction testing is a critical part of FCA's overall evaluation of the institution's collateral appraisal and evaluation practices. When examining individual collateral appraisals and evaluations, specifically evaluate the following items:

- Reasonableness of and support for the value assigned.
- Compliance with FCA regulations and the institution's collateral evaluation guidance, including appropriate use of the business loan exemption.
- Reliability of the independent collateral evaluation review to ensure effectiveness of this key control process. See the *Audit and Review* procedure for additional guidance.

**Selecting the Sample:** The extent of testing collateral appraisals and evaluations depends in part on the conclusions reached when completing the various *Collateral Risk Management* examination procedures. If examination results indicate the institution has adequate guidance and effective internal controls (including independent collateral review coverage and reliability) in place to ensure accurate collateral appraisal and evaluation practices, limited testing of individual appraisals and evaluations to verify these conclusions may be all that is necessary. Examiners may need to expand the sample if they identify weaknesses in collateral appraisals and evaluations 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, examiners may ask the institution to complete an independent review to fully test whether controls are working as intended. To determine the appropriate sample size for testing the institution's collateral appraisal and evaluation processes, examiners should also consider the following factors:

- Previous examination, internal review, or other third-party testing and results.
- Changes to collateral appraisal or evaluation guidance and the internal control environment.
- Changes in collateral evaluation operations or programs.
- Changes in management, collateral evaluation staff, or outside fee appraisers.
- Risk, growth, and trends in the loan portfolio.
- Economic conditions and any distressed industries.
- The institution's financial condition and performance.

When examination activities are warranted, examiners should review a sample of loans with recent collateral appraisals or evaluations (i.e., within 12 months). Examining recently originated loans with elevated collateral risk levels helps determine if the institution is requiring borrowers to have offsetting financial strengths when underwriting loans with elevated collateral risk. The sample should include loans secured by real estate and by chattel (as applicable) and include a sufficient number of accounts where the institution completed a collateral evaluation review. The real estate loan sample could include some loans where the income-producing potential of the secured property is limited, if the institution performs this type of lending (e.g., land in transition, recreational property). For non-real estate loans, the loan sample could include (to the extent possible) borrowers or industries under stress, loans with specialized collateral, livestock accounts, significant new money and new customer actions, and operations with complex ownership structures.

**Evaluating Testing Results:** In developing conclusions from transaction testing, examiners should focus on the overall accuracy of the institution's collateral appraisals or evaluations, rather than on individual appraisals or evaluations. For example, one or a few weaknesses in collateral appraisals or evaluations may not reflect a pattern or practice to support calling appraisal or evaluation processes less than satisfactory. Examiners should consider the underlying causes of weaknesses and if those factors could apply to other loans in the portfolio. To the extent that those factors apply broadly across the loan portfolio, a more critical conclusion on collateral appraisal or evaluation practices may be warranted. Conversely, when weaknesses are limited to collateral appraisals or evaluations evidencing certain characteristics or commonalities, conclusions on collateral appraisals or evaluations may be more effectively targeted to that particular aspect of the process. Transaction testing results should assist in answering the following key questions:

- Is the institution conducting collateral appraisals and evaluations in compliance with regulatory requirements?

- Is guidance effective in ensuring sound collateral appraisal and evaluation practices, and is it accomplishing the desired results?
- Are internal controls functioning effectively to ensure adherence to collateral appraisal and evaluation guidance and sound credit decisions?
- Is the independent internal credit review or collateral evaluation review accurately assessing collateral appraisal and evaluation and identifying practices that could lead to increased portfolio risk? Do the collateral appraisal and valuation weaknesses identified by FCA align with those reported in internal review reports?
- Do borrowers have adequate offsetting strengths in other financial factors to justify collateral underwriting standard exceptions?
- Are management's corrective actions effective in preventing the recurrence of previously identified collateral appraisal and evaluation weaknesses?
- Does a pattern of weak or unsatisfactory collateral appraisal and evaluation practices exist? Are any weaknesses material on either a loan specific basis or in aggregate?
- Do weaknesses contribute to inaccurate collateral values 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, appraiser, evaluator, or other common characteristic?