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March 8, 2018

To: Chair, Board of Directors

Chief Executive Officer

Each Farm Credit System Institution

From: Dallas P. Tonsager, Board Chairman and

Chief Executive Officer

Subject: Strengthening Lending and Loan Servicing Controls

The Farm Credit Administration issues this bookletter to provide further guidance on our expectation that each Farm Credit System (FCS or System) institution will continuously assess its lending and loan servicing controls to ensure controls remain effective and comply with FCA regulation [618.8430](https://ww3.fca.gov/readingrm/Handbook/_layouts/15/WopiFrame.aspx?sourcedoc=/readingrm/Handbook/FCA%20Regulation/618.8430.docx&action=default). This regulation outlines the minimum requirements that your institution’s lending and loan servicing controls program must meet.[[1]](#footnote-1)

A control program includes the policies and procedures the institution has established to manage risk and ensure the objectives of the board of directors are met. The controls help ensure that management carries out the board’s directives to manage risks identified through the risk assessment process. Material lapses in lending and loan servicing controls at even one System entity could expose the entire System to financial loss and reputation risk.

Effective controls — both preventive and detective controls — help your institution’s board of directors and management to meet the following objectives:

* Safeguard the institution’s resources.
* Produce reliable financial reports.
* Ensure compliance with laws and regulations.
* Reduce the possibility of significant errors and irregularities.
* Detect errors in a timely manner if they do occur.

Because of the importance of control activities, board members must provide direction to help management create a culture that will help ensure that lending and loan servicing controls are effective.

## Why we are issuing this bookletter

Regardless of your institution’s complexity and size, you need strong lending and loan servicing controls to decrease your credit, compliance, and reputation risk, as well as your funding costs.

Because your institution is part of the System, inadequate controls in your institution may also have significant implications for other System institutions and even the whole System. Material lending and loan servicing weaknesses can impair the System’s ability to issue timely combined financial statements and impact funding cost. We have worked closely with the Federal Farm Credit Banks Funding Corporation, System banks, and the System’s external auditor to stress the importance of lending and loan servicing controls.

In this bookletter, we stress the importance of lending and loan servicing controls and provide guidance institutions can use to strengthen these controls. Our recent examinations have focused on the following:

* Board and management oversight and accountability to ensure a strong control culture within the institution
* Implementation of key lending and loan servicing controls, such as segregation of duties, approvals, verifications, reconciliations, and access controls
* Communication of information between employees and management within the institution, especially in the upward communication of problems
* Internal credit review programs, audit, and monitoring activities

## How to establish effective lending and loan servicing controls

The following practices will help your institution guard against lending and loan servicing risks. Each institution has a unique and dynamic risk profile, so we urge you to continuously evaluate practices and enhance your controls where warranted. Your use of technology and business practices will also influence how you incorporate lending and loan servicing controls into your business processes. The practices listed below should be considered as part of your institution’s risk assessment process, the scope of your credit reviews and audits, and your policies and procedures. Exceptions to policies and procedures should be justified and documented.

Ensure segregation of duties.

Segregation of key duties is a fundamental element of an effective internal controls program. The basic premise is that no employee should be in a position both to perpetrate and conceal errors or fraud in the normal course of his or her duties. Different individuals should be assigned the responsibilities of originating loans, authorizing transactions, recording transactions, and maintaining custody of assets.

Your institution should regularly evaluate its processes for segregating duties. Involving different people in key lending and loan servicing steps helps your institution detect errors and reduces the opportunities for individuals to perpetrate and conceal fraud. Your institution should continuously evaluate how it segregates the following duties:

* Approving loans
* Disbursing and receiving funds (including wire transfers)
* Generating loans and managing relationships with borrowers
* Monitoring credit
* Processing loan charge-offs
* Collecting funds
* Posting to the ledger
* Reconciling
* Holding chattel and other collateral

Within these functional areas, further segregations may be required. For example, the same individual who is responsible for general ledger functions should not be able to post information in the loan system.

If you are unable to segregate these duties you will need to use mitigating controls. For example, if your staff is not large enough to allow for segregating all these duties, you may need to use other mitigating controls. This could include adopting a policy that requires officers and employees to be absent from their normal job duties with restricted access to systems for a specified period. These absences can be in the form of mandatory vacations, rotation of duties, or a combination of both. Required absences or rotation of duties, which are used by many financial institutions both inside and outside the FCS, are known to be effective in helping prevent and detect fraud.

1. Ensure proper use of delegated lending authorities.

Delegating lending authorities grants an employee or committee authority to approve loan actions (for example, to set loan terms and conditions and to approve certain types of loans and loan servicing actions, such as the release of collateral). These delegations generally are based on factors such as the dollar amounts involved and the risk ratings of the loans. Employees and committees with more seniority and experience generally hold delegated lending authorities for complex, larger, or higher-risk loans.

Your institution’s lending controls must include written policies, procedures, and processes for delegating lending authorities. These controls help ensure that no single individual has the sole authority to approve credit actions or manipulate data on large and complex loans, or other credits that present material risks to your institution’s financial condition and reputation.

Properly functioning delegated lending authorities and lending committees will help ensure that loans are approved according to the board’s risk appetite. They should also reduce your exposure to inappropriate practices or fraud that could lead to financial losses, litigation, and diminished reputation. To more effectively manage delegated lending authorities, you should consider taking the following measures:

* Develop written policies and procedures covering the use of delegated lending authorities. The policies and procedures for example should cover lending activities requiring delegated authority, disciplinary action for breach of policies and procedures, and a periodic review program.
* Monitor and report loan underwriting exceptions to the board and management to ensure that staff adheres to policies and procedures.
* Establish a formal and regular review of delegated lending authorities for staff at all levels.
* Require, when appropriate, a two-person approval process. For example, require the approval of both a credit analyst and a loan officer.
* Train all employees who hold delegated lending authorities on related policies and procedures.
* Ensure that policies and procedures require records to be kept of all decisions taken under delegated lending authorities.
* Keep meeting minutes and other materials to document approval processes for the review of board members, institution employees, FCA examiners, internal reviewers, and auditors.

1. Evaluate processes for loan originations, disbursements, and payments.

Your institution should have adequate lending and loan servicing controls to manage the complete lending cycle — from origination through maturity. These controls are needed to minimize the potential manipulation of loan proceeds or payments. To effectively manage this cycle, your institution should regularly re-evaluate the following:

* The segregation of the processes for loan closing, certification, payment, and funding
* The verification and authorization of disbursements or payments
* The verification of borrower requests for funds, including requests by email and phone (e.g., sight drafts)
* Wire authorizations (e.g., call-back or two-party verification systems)
* Processes for making corrections and adjustments to loan documents
* Written guidance for loan originations, disbursements, and payments
* Processes for evaluating the adequacy of controls over loan originations, disbursements, and payments
* The review, validation, and reconciliation of reports concerning loan originations, disbursements, and payments

1. Ensure that pledged collateral exists and is appropriately valued.

To avoid losses or under-collateralized loans, your institution’s management must verify the existence and value of pledged collateral, and ensure the accuracy of information reported by borrowers and loan officers. An inspection report that does not match the information reported by the borrower (such as the borrowing base report or financial statement) may indicate borrower distress or potential fraud. Material deviations must be explained and incorporated into the analysis. The following practices will help protect your institution against under-collateralized loans:

* Establish clear risk-based expectations for the frequency, timing, and depth of chattel valuations, and real estate appraisals.
* Perform site visits to verify the existence and condition of pledged collateral in accordance with established frequency expectations.
* Ensure the independence of real estate appraisers, personal property and chattel evaluators, and the collateral evaluation function as required by FCA regulations.
* Use real estate appraisals, as well as personal property and chattel valuations to verify and reconcile collateral values with the credit analysis and financial statements used in the underwriting process.
* Periodically review work completed by internal and external real estate appraisers, as well as personal property and chattel evaluators, including loan officers.

1. Use access controls to protect borrower information and institution data.

Appropriate access controls can help prevent and detect fraud and ensure the integrity of personal and private information of borrowers and employees. Management must establish appropriate access to confidential information regardless whether the information is electronic or physical and regardless how the information is accessed (e.g., by laptop, by phone, or in person). Consider using the following practices to ensure your institution has appropriate access controls:

* Establish appropriate system access privileges for employees, contractors, and third-party service providers. Consider the principle of “least privilege,” which gives an employee only the minimum set of access privileges needed to carry out his or her job responsibilities.
* Monitor access for excessive, unauthorized, or inappropriate activity.
* Conduct periodic independent reviews or approvals for individuals who perform multiple functions to minimize the potential for fraud, errors, and irregularities.
* Periodically verify that appropriate system access privileges were granted when employees were hired or promoted, and that system access privileges were removed when employees retired, were terminated, or had changes in their job duties.
* Review access logs and transactions to help protect confidential borrower information and support data integrity.
* Grant access to systems according to your institution’s written access control policies and procedures, and ensure that all employees follow these policies and procedures.

1. Conduct credit reviews and audits.

Institution boards and management are responsible for ensuring lending and loan servicing controls exist and operate effectively. This responsibility does not change whether the credit reviews and audits are outsourced or conducted in-house. Credit reviews and audits are critical for monitoring your controls’ compliance and effectiveness, and in identifying opportunities for improving these controls.

Credit reviews and audits must be sufficiently rigorous to identify and report the control weaknesses and to ensure compliance with policies, procedures, and regulations. Also, the board must hold management accountable for correcting material weaknesses in lending and loan servicing controls identified by internal and external parties. Consider using these practices when developing credit reviews and audits of lending and loan servicing:

* Create a multiyear plan that includes a risk assessment process to identify areas to be reviewed, to clearly define the scope of reviews, and to find opportunities to improve controls.
* Verify that the tools and processes your institution uses to track the status of corrective actions incorporate not only internal audit reports, but also external report findings, including FCA examination recommendations or required actions.
* Identify the individuals responsible for required actions and the deadlines by which the actions must be completed.
* Provide regular comprehensive progress reports to the board or the appropriate board committee.

Use the “Three Lines of Defense” model to minimize gaps in lending and loan servicing controls.

Consider using the “Three Lines of Defense” model for assessing your institution’s lending and loan servicing controls. The three lines of defense are as follows:

* Operational management
* Risk management and compliance functions
* The independent audit and credit review

Each line is responsible for the risks inherent in the institution’s operations and is accountable for maintaining or testing to ensure effective lending and loan servicing controls to safeguard assets and resources.

1. Establish clear roles and responsibilities to ensure accountability.

The board must establish clear expectations for the CEO and senior management to define roles and responsibilities for all employees. The board’s responsibilities in this area primarily involve oversight, authorization, and ethical leadership. Although board members do not design lending and loan servicing controls or prepare the written policies they adopt, they do help establish the culture around these internal controls. A board member can never delegate the responsibility to review and understand the lending and loan servicing controls policies and procedures the board approves.

The board in turn relies upon senior management to establish effective lending and loan servicing controls. Senior management relies upon managers and department heads to recommend and implement procedures. Ultimately, everyone in the institution has a responsibility to ensure that the lending and loan servicing controls program is operating effectively and efficiently.

1. Make lending and loan servicing controls part of your institution’s culture.

To make these controls part of your institution’s culture, your board must effectively communicate its expectations to management. The board must adopt policies that address the following areas:

* Lending, servicing, and decision-making authorities
* Segregation of duties
* Human capital management (e.g., employee qualifications, ethical standards)
* Operating and recording functions
* Compliance with laws and regulations

In turn, management establishes procedures and standards to implement the boards polices and effectively communicate the board’s expectations to staff. Finally, for these controls to become part of your institution’s culture, your board must ensure that all parties in the institution adhere to the established lending and loan servicing controls and safe and sound practices.

**Conclusion**

Your institution should continuously reassess and monitor the implementation of its lending and loan servicing controls. Of course, no matter how well designed and executed these controls may be, they cannot prevent all errors or acts of fraud. Limitations inherent in all control systems, such as collusion and management override, can reduce the effectiveness of lending and loan servicing controls. However, these controls can provide reasonable assurance that problems will not occur.

If you have questions about this bookletter, please feel free to contact any of the following FCA staff members:

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1. Please note that this bookletter does not apply to the Federal Agricultural Mortgage Corporation (Farmer Mac); FCA regulation 653.4 covers Farmer Mac. [↑](#footnote-ref-1)