

Farm Credit Administration

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INFORMATIONAL MEMORANDUM

August 29, 2016



To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit System Institutions

From: Gary K. Van Meter, Director
Office of Regulatory Policy

A handwritten signature in black ink that reads "Gary K. Van Meter".

Subject: Guidance on Addressing Personal and Intangible Property within Collateral
Evaluation Policies and Procedures (§ 614.4245)

This Informational Memorandum (IM) provides guidance on how the collateral evaluation policies and procedures maintained by Farm Credit System (System or FCS) institutions under FCA regulation § 614.4245 address the evaluation of personal and intangible property that is taken as security for a loan(s). FCA regulations require FCS institutions to develop and utilize an appropriate collateral evaluation process for the evaluation of any and all collateral, including personal and intangible property, taken as loan security. FCA regulation § 614.4240(m) defines “personal property” as “all tangible and moveable property not considered real property or fixtures.” Intangible property, while not specifically defined in the Collateral Evaluation regulations, is considered to be an item of worth that is not physical in nature. Examples include a copyright, trademark or goodwill, easements, leases, corporate logos or brand names, etc.

As the prospect for rising risk increases within the agricultural sector, the appropriate evaluation of personal and intangible property taken as security becomes increasingly important to the overall business of System institutions and their borrower-owners. Accordingly, FCA encourages each System institution to review the adequacy of its policies and procedures to ensure personal and intangible property evaluations are addressed. We are offering the guidance in this IM to aid in that review.

Background

In Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Congress addressed real estate appraisal concerns and established a framework for a revised real estate appraisal industry structure. While FIRREA does not specifically address personal and intangible property evaluation requirements, it does establish basic criteria and requirements for all collateral appraisal and evaluation activities, including personal and intangible property evaluations.

Although the FCA is not named in FIRREA as one of the Federal financial regulatory agencies covered by the provisions of Title XI, FCA recognizes that Congress, through the enactment of FIRREA, expressed a strong belief that all financial transactions involving real and personal property collateral should be supported by adequate and accurate collateral evaluations. Congress also expressed the belief that such collateral evaluations should be based on standards and guidelines that are consistently applied by the financial and appraisal industries.

Furthermore, the Congressional policy reflected in FIRREA has been supported and implemented by guidance issued by the Office of Management and Budget (OMB). OMB Bulletin 92-06 further extended Title XI real estate appraisal standards to Federal agencies subject to the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended (Uniform Act). The bulletin also directed all Federal agencies not subject to the Uniform Act to implement regulations that follow the appraisal requirements of FIRREA.¹ In response, FCA issued its collateral evaluation regulations, which are contained in 12 CFR Part 614, Subpart F. These regulations address the collateral evaluation requirements for real estate as well as personal and intangible property.

FCA continues to believe that following the collateral evaluation requirements of FIRREA and the overarching beliefs of Congress is an essential element of the safe and sound securitized lending activities conducted by the System.

Collateral evaluation policies and procedures for personal and intangible property

FCA regulation § 614.4245 requires the board of directors of each FCS institution to adopt policy guidelines for the completion and use of evaluations of all loan collateral, including personal and intangible property. Within the context of these policies and procedures, § 614.4245 requires setting well-defined parameters for achieving consistent and reliable valuations of collateral property. Among these parameters are the requirements that evaluations of personal and intangible property be completed by a qualified evaluator² and be based on a market value that is documented through a written report. During the 1991-92 rulemaking for current collateral evaluation regulations,³ commenters agreed that the evaluation of personal property collateral should be addressed in the policy and procedures adopted by the lending institution similar to requirements of other financial institutions. While

¹ OMB Bulletin No. 92-06, dated March 16, 1992, entitled "Guidance on Real Estate Appraisal Standards and Practices," extended Title XI real estate appraisal standards to agencies subject to the Uniform Act, which was implemented by regulations in 49 CFR part 24.

² A "qualified evaluator," as defined in § 614.4240(n), "means an individual who is competent, reputable, impartial, and has demonstrated sufficient training and experience to properly evaluate property of the type that is the subject of the evaluation. For the purposes of this definition, the term "qualified evaluator" includes an appraiser or valuator." For purposes of personal and intangible property valuations, a qualified evaluator could include a loan officer, staff appraiser, contract fee appraiser, or other industry experts knowledgeable of the type of collateral being valued.

³ 57 FR 54683. In addition to soliciting public comments to a proposed rule, the FCA held public hearings on its collateral evaluation regulations. The hearings were held for 4 days and had 121 respondents. Notice of Public Hearings, May 10, 1991 (56 FR 21637).

comments varied in how that was to be done, they generally agreed that procedures to identify personal property values should be well defined and provide for ongoing monitoring of those values with appropriate documentation and with an objective internal review process.

Collateral evaluation policies and procedures for personal and intangible property should also address the types of published sources that may be used in the evaluation process and for which types of properties or loans those sources are most appropriately used. For example, the policy may identify a series of published sources acceptable when identifying the value for new or used equipment and commodity market reports. However, institutions are cautioned that such sources should not be the *sole basis* for determining market value, as that term is defined in § 614.4240, where conditions such as special financing terms, special sales, interfamily sales, or leasing concessions may affect the market value.

If a System institution's loan officer or other staff are developing the personal and intangible property evaluation, it is expected that they review and evaluate the subject property in person. If the evaluation is completed by a fee appraiser, then the regulations (§ 614.4266(d)) require the appropriate institution staff to perform a physical inspection to identify the location and condition of the personal and intangible property being evaluated. Such initial inspections by association staff may be made as part of the collateral evaluation process or as part of routine loan servicing visits.

When an inspection is required, it is the responsibility of the institution to establish the appropriate guidance and controls for conducting such inspections, which should include:

- Determination of who is to conduct the inspections (loan officer, staff or fee appraiser, external contract expert, etc.),
- The level of inspection required commensurate with the type of collateral to be inspected and valued (livestock, equipment, stored grain, stored corn or soybean oil, growing crops, feed stock, highly unusual or specialized property, treasury instruments, etc.), and
- Determination of the purpose for the inspection (evaluation, follow-up inspection, update evaluation, etc.).

Verification of any existing or newly financed collateral serving as security is essential, especially when such collateral is an integral part of the loan repayment plan. It is important to remember that personal and intangible property can constitute a significant portion of the collateral used to secure a FCS institution's short- and intermediate-term loans. As such, initial and periodic inspections of personal and intangible property is a critical aspect of credit administration. Historical losses for commercial lenders and FCS associations associated with personal and intangible collateral have often centered around customer fraud and the lack of appropriate controls at the institution level.⁴ Inclusion of appropriate inspection practices

⁴ Examples include, but are not limited to: Unknowingly using the same collateral on different loans, commingling of assets, cattle inventory being counted over several days with the cattle moved to different sites overnight, use

specific to the type of collateral helps ensure a valid evaluation, periodic follow-up inspections, and collateral control.

Collateral evaluation of personal and intangible property

At the beginning, when an institution is considering taking personal or intangible property as security for a loan (or when it is the subject of a lease), an evaluation of such property must be performed in accordance with the institution's own policies and procedures, as well as §§ 614.4260 and 614.4266. We remind institutions that while FCA regulation § 614.4260(c)(3) provides an appraisal exemption for real estate taken under an "abundance of caution,"⁵ this regulatory exemption does not extend to personal and intangible property.⁶

Under FCA regulation § 614.4266, all collateral evaluations of personal and intangible property are required to:

- Value the property on the basis of market value, in accordance with the institution's evaluation standards and policies;
- Include a source of comparisons of value (i.e., equipment dealer listings, Blue Book, market sales reports, etc.);
- Contain a description of the property being evaluated, including the property's location, quantity, species or variety, measure or weight, value per unit and total value, how the property is identified (e.g., serial number, brand, bill of lading, warehouse receipt), as well as quality, condition and age of the property; and
- Include a review and description of the documents supporting intangible property interests and its marketability (e.g., applicable terms, conditions, and restrictions contained in the document that would affect the value of the property).

The procedures used to identify personal and intangible property values should be well defined, documented and provide for ongoing monitoring of those values.

Depending on the circumstances, evaluations of personal and intangible property may be required as either a valuation or an appraisal. Typically, the value of personal and intangible property will be captured in a valuation instead of an appraisal. However, an appraisal of such collateral may be required when the institution determines it necessary due to the distressed condition, size, complexity, or the specialized nature of the collateral.⁷ In either case, it is

of false tops and floors to mask the true volume of grain or oil stored in storage elevators or containers, ear tags changed at the feedlot to allow the undetected diversion of cattle to cash by the feedlot owner, and the lack of appropriate experience of staff for evaluation and inspection of specialized personal or intangible property.

⁵ "Abundance of caution" means collateral taken that is not required to support the credit decision, when evaluated on the five basic credit factors, since other sources of repayment or collateral sufficiently support the credit decision.

⁶ The "abundance of caution" exception contained in § 614.4260(c)(3) provides for the use of a collateral valuation rather than a USPAP appraisal when valuing real estate collateral. It does not extend to other types of collateral.

⁷ The FCA may require an appraisal under this subpart whenever it believes it is necessary to address safety and soundness issues. 12 CFR § 614.4260(d).

important that the collateral evaluation be identified as either a collateral valuation or an appraisal. Also, where an evaluation is completed by a fee appraiser, FCA regulation § 614.4266(d) requires that the institution's evaluation standards include provisions for periodic collateral inspections and other verification by the institution's account officer or other designated staff.

Internal controls

FCA believes that objective internal review processes are essential with regard to personal and intangible property evaluations because of the increasing and extensive use of such property as loan collateral within the System. FCS institutions are required by § 618.8430 to develop and implement appropriate internal controls and internal review processes. When addressing collateral evaluations, the internal controls must ensure that staff conducting the evaluations are "qualified evaluators" who are appropriately trained and experienced in conducting the subject evaluation. It is also important that internal controls exist to ensure collateral evaluations are conducted in an objective manner and represent supportable values.

In establishing controls to ensure collateral evaluations are conducted objectively, institutions should refer to FCA regulation § 614.4255, which sets the independence requirements. Under this provision, certain persons are prohibited from conducting personal and intangible property (and real property exempted under § 614.4260(c)) evaluations. These prohibited persons include persons with a direct or indirect interest, financial or otherwise, in the loan or subject property, or directors who will or have voted on (or otherwise approved) a loan decision for which the collateral serves as security.

If the institution's internal control procedures require either a prior approval or post-review of credit decisions, appropriate safeguards are needed for implementing these activities, especially if the institution's evaluation procedures allow officers and employees to participate in a vote on or an approval of a credit decision involving security they evaluated. When a loan officer is making a loan and conducts the associated collateral valuation, such valuation should be completed within the guidelines established by the institution's standards and policies. Such guidelines must address the use of prior or post approvals. Clear and up-to-date internal control procedures are essential for institutions allowing this interrelationship between the loan making decision and the evaluation process. It is especially important that internal controls exist to oversee implementation of FCA regulation § 614.4250(a)(7), which requires certification within the evaluation report that the value reached was not based upon a requested amount.

Questions and answers

To assist institutions in reviewing the adequacy of policies and procedures for personal and intangible property evaluations, we are providing a few of the questions we have received on the subject, and our answers to those questions, below.

Q1: Is an evaluation required for any or all collateral taken as security for a loan or lease?

A1: Yes. All FCS institutions are required to have an up-to-date collateral evaluation for each item of collateral taken to secure a loan or lease. There is more flexibility in the evaluation requirements for personal and intangible property evaluations than for real estate evaluations.

Q2: May a loan officer from the System institution that is financing the debt complete the collateral evaluation for personal and intangible property security if the loan officer is the same person handling the loan?

A2: Maybe. A loan officer may complete the evaluation if designated as a “qualified evaluator” by the institution. However, it is the responsibility of the FCS institution to have appropriate controls in place to ensure that there is no corruption of the evaluation process by the loan officer and affiliated loan staff that would jeopardize the integrity of the collateral evaluation and loan decision processes. Under § 614.4255, institutions must ensure that no person performs personal and intangible property evaluations for transactions in which such person has a direct or indirect interest, financial or otherwise, in the loan or subject property. The institution’s internal controls and review processes are a key component of the controls the institution is required to have in place to ensure the integrity of the evaluation and credit decision processes.

Q3: Is an inspection required before completing an evaluation of personal and intangible property taken as security for a loan or lease?

A3: As a general rule, all property subject to an evaluation should be inspected. It is especially important that property which is being evaluated for the first time be inspected. Evaluations that are being issued to update an existing value may not require an extensive inspection, but it is a good practice to conduct some type of visual observation to determine any deterioration or change to the property. Evaluations conducted under USPAP standards must follow USPAP requirements for inspections. In addition, if a fee appraiser conducts the evaluation, the institution is required to follow-up with its own inspections of the property under FCA regulations §§ 614.4265(g) and 614.4266(d).

Q4: How extensive should an inspection of personal and intangible property be for an evaluation?

A4: The initial inspection of any collateral evaluation identifies the type, location, and condition of the property, and any special conditions or issues associated with the property. In the case

of personal or intangible property, often the type of intangible or personal property will indicate the extent of any inspection.

Q5: Are periodic inspections required of personal and intangible property taken as security for a loan or lease?

A5: Initial and periodic inspections of personal and intangible property collateral is a critical aspect of credit administration since this collateral can constitute a significant portion of that used to secure short- and intermediate-term loans and often serves as a significant source of loan repayment. Historical losses, both for commercial lenders and FCS associations, have often centered around customer fraud and the lack of appropriate controls at the lender level over personal and intangible property collateral. Inclusion of appropriate inspection practices specific to the type of collateral helps ensure a valid evaluation, periodic follow-up inspections, and collateral control.

Q6: What are the evaluation requirements for personal and intangible property taken as an “abundance of caution”⁸?

A6: All personal and intangible property taken as collateral requires an evaluation and when personal and intangible property is taken as security out of an “abundance of caution”, the evaluation is normally in the form of a valuation.⁹ In personal and intangible property “abundance of caution” situations, it may be enough for the valuation to be based on the general purchase price for the same or similar items (i.e., the purchase price an average person would pay) as of a specific date. The price paid by the average person is used to avoid distortions in valuations where conditions such as special terms, sales, or volume concessions may have affected the actual purchase price. At a minimum, personal and intangible property secured out of an “abundance of caution” requires a basic valuation that:

- Documents that the personal and intangible property is not necessary, as security, to support the loan decision,
- Identifies the personal and intangible property being taken as security, including type of property, location, and general condition, and
- Estimates a value for the personal and intangible property, which may be conservatively estimated based on the type of property and level of inspection completed.

⁸ FCA regulation 12 CFR 614.4240(a) defines “abundance of caution” as collateral taken as security in circumstances in which it is not required by statute, regulation, or the institution's policies, and it would not be required by a prudent lender to support the credit decision as the credit was extended based on other revenue or collateral.

⁹ FCA intends to review existing regulatory evaluation requirements for non-real estate collateral taken under an “abundance of caution,” including when such collateral is taken as an abundance of caution under score card lending programs.

The manner of completing valuations of personal and intangible property for “abundance of caution” situations should be addressed in the institution’s collateral evaluation policies and procedures.

Q7: When conducting the credit analysis, is an institution required to use the full valuation amount of personal and intangible property that was taken under an “abundance of caution”?

A7: No. While a valuation of the personal and intangible property is required, an institution may use its own discretion on whether to use the full value in the credit analysis and loan portfolio management (LPM) processes. This means that none or only a portion of the full collateral value of the personal or intangible property taken out of an abundance of caution could be used in the credit decision itself (e.g., full valuation is \$10,000, but a zero value is input into the credit analysis and LPM processes). Institutions should document applicability and documentation expectations for taking personal and intangible property out of an abundance of caution, which may include on a portfolio/program-wide basis, through policies and procedures. Typically, when personal and intangible property is taken out of an abundance of caution, the loan file should document that the application, when evaluated on the basic credit factors, supports the credit decision without the “abundance of caution” collateral. In cases where the credit is considered less than acceptable, including collateral taken out of an “abundance of caution” requires additional support and documentation.

Q8: Do the § 614.4260(c) *de minimis* or business loan exceptions for appraisals apply to personal or intangible property evaluations?

A8: No. The exceptions of FCA regulation § 614.4260(c) apply to real estate appraisal requirements. If elsewhere in our rules an appraisal, as opposed to a valuation, is required for real estate security, § 614.4260(c) provides some very specific exemptions from conducting an appraisal. These exemptions do not extend to non-real estate security. Thus, there is no *de minimis* or business loan exemption to conducting appraisals for personal or intangible property. However, most personal and intangible property security do not require appraisals, but, at a minimum, require a basic valuation. An appraisal of such collateral may be required when the institution determines it necessary due to the distressed condition, size, complexity, or the specialized nature of the collateral.

If you have any questions about this Informational Memorandum, please contact Dennis K. Carpenter, Senior Policy Analyst, Office of Regulatory Policy, at (703) 883-4464, or by email at carpenterd@fca.gov; or Mark L. Johansen, Associate Director, Credit and Mission Team, Office of Regulatory Policy, at (703) 883-4064, or by email at johansenm@fca.gov.