
Informational Memorandum



April 21, 2008

To: Chief Executive Officer
All Farm Credit System Institutions

From: Andrew D. Jacob, Director
Office of Regulatory Policy

A handwritten signature in black ink that reads 'Andrew D. Jacob'.

Subject: Collateral Evaluation Requirements and Frequently Asked Questions

A change to the Farm Credit Administration (FCA) collateral evaluation regulations has prompted the FCA to issue this informational memorandum (IM) to provide guidance to Farm Credit System (FCS or System) institutions. This regulatory change, coupled with significant growth in the System's assets, furthers the need for the board of directors of each institution to ensure that its collateral evaluation review programs are sufficient to minimize risk to the institution's assets from adverse trends in real property values and for compliance with FCA regulations.

This IM also serves to reinforce existing guidance concerning collateral evaluation requirements. In particular, we are issuing this IM to ensure that institutions have a clear understanding of the rules affecting collateral evaluations for real property used for securing "business loans" and that institutions apply the appropriate method of evaluating collateral. Boards of directors have the responsibility to ensure their institutions comply with FCA collateral evaluation regulations, and, when appropriate, follow the Uniform Standards of Professional Appraisal Practice (USPAP). Specifically, this IM:

1. Communicates that FCA collateral evaluation requirements were recently amended to remove the condition for a USPAP-compliant appraisal of real property collateral on business loans between \$250,000 and \$1.0 million.
2. Discusses FCA's definition of "business loan," the intended purpose of the business loan appraisal exemption, and what types of loans do not qualify for the business loan appraisal exemption.
3. Emphasizes that even though appraisals are not required for real property collateral on loans that qualify for the business loan appraisal exemption, a "valuation" still needs to be completed that meets the requirements outlined in FCA regulations.

4. Reminds institutions that computer-based models may be appropriately used to complete collateral evaluations in some situations and reemphasizes the need to validate computer-based models as discussed in FCA's June 17, 2002, IM.¹
5. Reminds System institutions of the need to maintain adequate controls and review programs over the collateral evaluation process concerning real property appraisals and valuations in accordance with FCA regulations.
6. Notifies institutions that additional guidance on collateral evaluation requirements will be maintained on FCA's website in the form of Frequently Asked Questions (FAQs).

Clarification of Business Loan Appraisal Exemption and Definition

Business Loan Appraisal Exemption

Before February 1, 2007, FCA regulations on collateral evaluations (Part 614, Subpart F) required that real estate appraisals or real estate collateral valuations for business loans between \$250,000 and \$1.0 million be prepared according to USPAP unless otherwise exempt. Effective February 1, 2007, FCA removed this provision from § 614.4265 of the regulations.² When the FCA removed this provision, it did not remove the requirement for real property collateral evaluations for all business loans. Business loans not exempt under § 614.4260(c) must still meet regulatory appraisal requirements. Exempt business loans, discussed below, do not require appraisals, but still need to have valuations of real property collateral.

Definition and Intent of the Business Loan Appraisal Exemption

Our business loan definition, which is similar to the definition used by other Federal financial regulatory agencies, is:

Business loan means a loan or other extension of credit to any corporation, general or limited partnership, business trust, joint venture, sole proprietorship, or other business entity (including entities and individuals engaged in farming enterprises).

[§ 614.4240(e)]

The business loan appraisal exemption is intended for loans to borrowers operating small- and medium-sized businesses, including farming operations, where the owners are subject to the risk of operational losses.³ This appraisal exemption was provided in FCA regulations because the additional cost of an appraisal was viewed as burdensome on these borrowers and not necessary to ensure the safety and soundness of System institutions.

The business loan exemption is not intended to ease appraisal requirements for real estate investors or passive landowners.⁴ To qualify for the exemption, the business loan cannot be dependent on income derived from the sale or cash rental of real estate as the primary source of repayment⁵, and must have a transaction value of \$1.0 million or less.⁶

¹ See "Computer-based Model Validation Expectations" IM at www.fca.gov under "Additional Guidance".

² See 71 FR 65383 (Nov. 8, 2006).

³ See 59 FR 46725 (Sept. 12, 1994).

⁴ See 59 FR 46725 (Sept. 12, 1994).

⁵ See 12 C.F.R. § 614.4260(c)(2)(ii).

⁶ See 12 C.F.R. § 614.4260(c)(2)(i).

Institutions must have documentation justifying the use of appraisal exceptions in the applicable loan file(s). Further, to ensure consistent and appropriate application of the business loan exemption, FCS institutions are encouraged to establish procedures for determining whether borrowers are engaged in farming enterprises subject to the risk of operational losses and, therefore, justified to benefit from the business loan appraisal exemption. Attached is a flow chart⁷ and examples⁸ that can be used as guidance in applying the business loan appraisal exemption.

Valuations Required in the Application of the Business Loan Appraisal Exemption

FCA's regulation on collateral evaluation standards states "[w]hen real, personal, or intangible property is taken as security for a loan or is the subject of a lease, an evaluation of such property shall be performed in accordance with § 614.4260 and the institution's policies and procedures. Such collateral evaluation shall be identified as either a collateral valuation or a collateral appraisal."⁹ A valuation is defined as an estimate of value for a property, while an appraisal is a written statement of opinion on the market value of property.¹⁰ Even though an appraisal is not required on business loans of \$1.0 million or less, System institutions still must complete a "valuation" in accordance with requirements in §§ 614.4250, 614.4260, and 614.4265.

Use of Computer-based Models for Collateral Evaluations

The FCA is aware that institutions are increasingly using computer-based models for collateral evaluations. When used with homogenous data, a valid collateral value can be statistically determined. Nonetheless, with the diversity of commodities in certain districts and developmental influences on property values, institutions need to ensure sufficient data is available to statistically determine accurate collateral values. Therefore, the appropriate application of computer-based models should be determined through an independent validation process as defined in FCA's June 17, 2002, IM on this topic. Further, when a computer-based model is used to complete an appraisal, industry standards dictate that it complies with all applicable USPAP standards and is signed by a State-licensed or certified appraiser.

Collateral Evaluation Review Programs

Given the significant asset growth experienced by the System over the past several years, we believe it is appropriate and necessary to remind institutions' boards of directors of FCA's expectations concerning their institutions' collateral evaluation review programs.

FCA regulations require an institution to adopt well-defined and effective collateral evaluation policies and standards. In addition, § 618.8430 of our regulations requires an institution to maintain internal controls to "review and assess its assets," including appraisal review standards. Accordingly, the FCA expects institutions' boards of directors to ensure that collateral evaluation review programs are maintained sufficient to ensure compliance with FCA's collateral evaluation standards and the institution's own policies and procedures. Further, the scope of collateral evaluation review programs should include:

⁷ See "Business Loan Exemption for Transactions over \$250,000" flow chart (Attachment 1)

⁸ See "Determining When to Apply the Business Loan Exemption for Transactions Over \$250,000" (Attachment 2)

⁹ See 12 C.F.R. § 614.4250(a).

¹⁰ See 12 C.F.R. § 614.4240(b) and (v).

- Both appraisals and valuations – on portfolio loans, as well as those sold into the secondary market;
- The adequacy of the institution’s ongoing oversight and internal controls for administering the work of qualified evaluators;
- The institution’s program for determining who qualifies as an evaluator; and
- Policies, procedures, and practices in accordance with FCA’s guidance on computer-based model validation expectations.

Guidance on Collateral Evaluations: FAQs

This IM represents the most relevant and up-to-date guidance to institutions for compliance with FCA’s collateral evaluation regulations, as well as our expectations regarding collateral evaluation review programs. In addition, ongoing guidance on collateral evaluations will be provided in the FAQs to ensure that we keep pace with changes in collateral evaluation practices. The FAQs will be maintained at www.fca.gov under “About FCA”.

If you have any questions, please contact Barry Mardock in the Office of Regulatory Policy at (703) 883-4456 or mardockb@fca.gov, Hal Derrick in the Office of Examination at (703) 883-4266 or derrickh@fca.gov, or me at (703) 883-4356 or jacoba@fca.gov.

Attachments: (1) “Business Loan Appraisal Exemption Considerations for Transactions Over \$250,000”
(2) “Determining Whether to Apply the Business Loan Appraisal Exemption to Transactions Over \$250,000”