



### EM-22.3

**Category:** Loan Portfolio Management

**Topic:** Credit Administration

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#### Overview

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

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

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

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

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

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

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

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

## **Examination Procedures and Guidance**

### **General Credit Controls**

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

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

## Guidance:

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

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

- **Regulatory Compliance: Has the institution developed sufficient credit administration guidance and standards as required by FCA Regulation [614.4150](#)?** This regulation identifies the minimum requirements for credit guidance and standards that reflect prudent lending practices and ensure compliance with all applicable laws and regulations. The extent of credit guidance may vary depending on the complexity of lending activities and the institution's risk profile. Additionally, FCA Regulation [616.6300](#) requires that any leasing activity comply with the requirements in FCA Regulation [614.4150](#), and identifies additional policy and procedure requirements specific to leasing.
- **Financial Information: Does guidance sufficiently address financial information requirements?** FCA Regulation [614.4150\(a\)](#) requires that lending guidance prescribe the minimum supporting credit and financial information, frequency for collecting information, and verification of information required in relation to loan size, complexity, and risk exposure. Guidance should address both the acceptable age and reliability of financial information, as well as expectations for preparing financial projections. Guidance should also provide direction on adjusting applicant supplied financial information (e.g., current asset value updates, cost basis to market value adjustments, cash to accrual adjustments). The quality of financial information obtained and related verification requirements can range from collecting basic financial information for scorecard loans to requiring audited statements for large, complex operations. Refer to FCA's Informational Memorandums on [Loan Underwriting Standards - Borrower Financial Information](#) dated March 29, 2011, and [Servicing Loans to Borrowers in Distressed Industries](#) dated January 21, 2016, for criteria when evaluating financial information requirements. Additionally, the institution should have guidance on consolidating financial information when the credit decision is based on the financial condition of multiple borrowers or entities. The guidance should also address consolidating financial information from related borrowers that have loans meeting the regulatory attribution criteria in FCA Regulation [614.4359](#).
- **Credit Analysis and Decision: Does guidance sufficiently address expectations for analyzing credit risk and making credit decisions?** FCA Regulation [614.4150\(b\)](#) requires each institution to develop procedures for credit analysis. These procedures should define the institution's approach to analyzing the five credit factors (commonly referred to as the 5 C's of credit) to conclude on the borrower's creditworthiness. Credit analysis guidance needs to incorporate measurable underwriting standards as required by FCA Regulation [614.4150\(g\)](#).

As further specified in FCA Regulation [614.4150\(g\)\(1\)](#), the institution must have standards for determining whether an applicant has the operational, financial, and management resources necessary to repay the debt from cashflow. Additionally, FCA Regulation [614.4150\(i\)](#) requires that guidance address documentation of compliance with loan underwriting standards and compensating strengths when standards are not met. Refer to additional guidance in the *Loan Underwriting Direction* Examination Manual topic. The institution may choose to communicate credit analysis and decision-making guidance in conjunction with loan underwriting or risk rating guidance.

- ***Loan and Legal Documents: Does guidance sufficiently address the loan and legal document requirements for making and servicing loans?*** Guidance should identify and address the applicable loan and legal documents for making and servicing a loan. Most importantly, guidance should cover the documents necessary to evidence the debt obligation and secure the collateral, such as loan agreements, promissory notes, and security agreements. FCA Regulation [614.4200](#) requires these types of documents to identify the loan terms and conditions. Documentation requirements may vary depending on the size and type of loan and the type of collateral securing the loan. Guidance should include direction for perfecting security interests (e.g., filing financing statements, obtaining a mortgage or deed of trust), as well as lien certification requirements covered in FCA Regulation [615.5060\(a\)](#). There should also be guidance addressing documentation on loans to entities, as well as guidance for loans with guarantees or special conditions that would have additional documentation requirements. As a sound business practice, the institution should have processes to ensure documents are appropriately recorded and updated, as necessary. For example, the institution may use an independent, post-closing review of the documents that is differential based on risk.
- ***Loan Terms and Conditions: Does guidance sufficiently address expectations for establishing loan terms and conditions?*** Guidance needs to address requirements that loan terms and conditions be appropriate for the loan, in accordance with FCA Regulation [614.4150\(h\)](#). Loan amortization and maturity should be reflective of the expected useful life of the asset financed. Loan repayment structure should match the expected cash flow of the enterprise providing the primary source of repayment, and repayment should not be dependent on one-time, unusual sources such as the sale of collateral or production assets. If the institution uses balloon structures or interest only terms, guidance should provide direction on the appropriate use of these structures. Loan covenants and conditions provide lenders a mechanism for controlling risk in the account. Examples could include requiring financial covenants such as minimum working capital or equity, submission of borrowing base reports, or a credit enhancement such as a government guarantee. Guidance should also address other regulatory requirements related to loan terms and conditions, including:
  - FCA Regulation [614.4200\(a\)](#) requires that all terms and conditions be set forth in written documentation no later than loan closing.
  - FCA Regulation [614.4200\(b\)](#) addresses security requirements based on the term of the loan, including the need for board policy to address any actions that will result in exceeding the loan-to-value limitation on long-term real estate mortgage loans. FCA's Informational Memorandum on [Clarification of FCA Regulation 614.4200\(b\)\(1\) – Security for Long-Term Loans](#) dated May 11, 2006, provides additional guidance on security requirements for long-term loans.

- FCA Regulation [614.4200\(c\)](#) requires that if a direct lender amortizes a loan over a period of time longer than the term to maturity, resulting in a balloon payment, the lender must set the amortization schedule consistent with the institution's loan underwriting direction. Loan underwriting policies, procedures, or standards need to ensure that the amortization schedule is appropriate to the type and purpose of the loan, expected useful life of the asset being financed, and the repayment capacity of the borrower. It is important that this direction be clear on the requirement to address amortization in relation to the expected useful life of the asset being financed and not the collateral for the loan, which might have a longer useful life. Loan underwriting direction needs to ensure that compliance with these requirements is evaluated when a loan is extended and each time a balloon payment loan is refinanced.
- FCA Regulations in Part 614, subpart A address maturity limits for short- and intermediate-term loans as well as long-term mortgage loans. Loan terms must comply with respective lending authorities. Refer to the *Lending Authorities & Territories* procedure for additional details on examining compliance with these requirements.
- **Loan Servicing: Does guidance sufficiently address both routine and distressed loan servicing expectations?** Loan servicing involves monitoring, controlling, and managing a loan from origination through collection. Guidance should include expectations for all aspects of loan servicing commensurate with the risk in the account. This includes ongoing servicing of all loans and handling routine servicing actions, as well as the increased servicing needed on past due and higher risk accounts. FCA Regulation [614.4170](#) states that direct lenders are responsible for servicing loans they make unless otherwise designated in a participation agreement. This regulation requires that institutions develop loan servicing policies and procedures for term loans, operating loans, and loans to legal entities. Refer to the regulation for specific items that must be addressed. In addition:
  - Guidance should include expectations for routine servicing requirements, including monitoring compliance with general terms and conditions and formally documenting and communicating with the borrower any areas of noncompliance. Guidance should also address expectations for handling routine servicing requests (e.g., partial release of collateral, extensions, subordination requests, covenant waivers, release of insurance proceeds).
  - Guidance should establish the frequency for collecting financial information, performing subsequent lien searches, obtaining updated credit reports, and completing updated collateral evaluations. As outlined in FCA Bookletter [BL-037](#), it's the institution's responsibility to obtain current and reliable financial information on borrowers to properly measure and manage risks in the loan portfolio and determine the allowance for losses. Timely identification of adverse trends and conditions helps the institution address factors that have increased risk before loan collectability is materially impacted.
  - Guidance should address loan servicing plans. Loan servicing plans are an effective tool for outlining servicing actions on credits that require additional attention beyond the controls and monitoring established at origination. In most cases this would involve criticized loans but could also include large or complex loans or other

material exposures that are classified Acceptable but showing increased risk. Guidance should define when loan servicing plans are necessary, how frequently they are to be updated, and what information should be included. Refer to FCA's Informational Memorandum on [Servicing Loans to Borrowers in Distressed Industries](#) dated January 21, 2016, for additional guidance on loan servicing. Also, [FCA Board Policy Statement 71 - Disaster Relief Efforts by Farm Credit Institutions](#) provides considerable flexibility under FCA Regulations to provide disaster relief to borrowers.

- **Guidance Updates: Does the institution have processes that ensure credit administration guidance remains current and relevant for the lending environment?** As discussed in FCA Bookletter [BL-037](#), the board and management should periodically review lending practices and standards to ensure they remain appropriate. Credit administration guidance needs to be updated on an ongoing basis for changing risk conditions, new or revised lending programs, new lending authorities, changes in regulatory guidance, staffing changes, and any other material changes in the lending environment. For example, guidance updates may be needed if the institution becomes involved in a new program such as capital markets lending or when there is a concentration in a commodity that is under stress. Guidance should be dynamic and change with the risk environment.
- **Communication of Guidance: Do communication processes ensure staff are aware of and understand credit administration guidance?** The institution should adequately communicate to staff the requirements for administering credit. Credit guidance should be easily accessible to employees, and management should have a process for effectively communicating credit guidance changes. Examiners can use internal review results and FCA's transaction testing to evaluate the effectiveness of credit administration guidance and how well it appears to be understood and followed by staff.

Note: Loan pricing practices, loan underwriting direction and standards, and collateral administration relate directly to credit administration but are not specifically addressed above. Refer to the applicable Examination Manual topics (*Earnings Management*, *Loan Underwriting Direction*, and *Collateral Risk Management*, respectively) for information on examining guidance and standards in these areas and consider the results when concluding on the adequacy of credit administration guidance. Additionally, refer to FCA Examination Bulletin [2009-2](#) when examining guidance on financing land in transition at institutions involved in this type of lending.

## 2. Internal Controls:

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

### Guidance:

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

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

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

Note: In the Institute of Internal Auditors' (IIA) [Three Lines Model](#), management's responsibility falls in both first and second line roles. This section focuses on the first and second lines which are the controls implemented by front-line operating managers and credit risk managers to own, manage, and monitor risks. To evaluate the third line, which involves internal audit providing independent assurance of the control framework, refer to the *Audit/Review* procedure. Additionally, refer to the *Transaction Testing* procedure for FCA review of loans to evaluate the effectiveness of lending controls.

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

- **Segregation of Duties: Are credit administration duties and functions reasonably separated to prevent errors, fraud, or unauthorized actions?** The possibility of errors and fraud diminishes significantly when there is a segregation of duties – that is, when two or more people are required to complete a transaction. The segregation of duties allows one person to verify that transactions initiated by another employee are properly authorized, recorded, and settled. When establishing segregation of duty standards, management should assign responsibilities so that one person cannot handle a transaction from inception to completion. For example, a loan officer should not perform more than one of the following tasks: originate a loan, disburse loan proceeds, or accept loan payments. Individuals with authority to sign official checks should not reconcile check ledgers or correspondent accounts, and personnel that originate transactions should not reconcile the entries to the general ledger. FCA Bookletter [BL-069](#) provides more information on segregation of duties and lending controls. In addition, the adequacy of segregation of duties around the lending function is an integral part of internal controls over financial reporting (ICFR), which is addressed in the *Financial Reporting Controls* procedure in the *Financial & Shareholder Reporting Examination Manual* topic.

- Disbursement/Payment Controls: Does the institution have well-defined processes for loan origination, disbursements, and payments?** The institution should have processes and controls to minimize the potential manipulation of loan proceeds or payments. For example, controls should ensure only legitimate, approved loan requests are funded, that funds disbursed are received by the intended parties and used for the intended purposes, and that loan payments received are deposited and credited to the appropriate borrower's account. These credit administration controls extend beyond the credit function to loan accounting, accounts payable, investments, information systems, and other departments or staff. FCA Regulation [614.4150\(c\)](#) requires that guidance outline the minimum requirements for disbursement, servicing, and collections. Throughout the lending cycle, management must maintain processes to ensure verification and authentication of transactions. This should include an independent review of borrower information supporting a credit request. Someone independent from the originating loan officer should verify borrower identity and loan signatures at closing and verify loan disbursement requests are authorized and accurate. Management should also adopt controls to ensure billing statement accuracy and provide clear guidance for administering account adjustments, disputes, or applying funds outside the terms of the credit agreement (e.g., excess funds or transfer from one loan to another). For institutions that rely on automated disbursement and payments systems, management should ensure appropriate controls are in place and functioning as intended and any exceptions are appropriately flagged. For more guidance about payment system information technology general controls, see the *Payment Systems* procedure in the *Information Technology and Security* topic. Depending on the institution's staffing and complexity, processes may require different types of controls to disburse loan proceeds or apply loan payments. Segregation of duties in this area is critical and in cases where full segregation of duties is not practical, management should identify ways to compensate for the risk (e.g., dual custody, post review processes). FCA Bookletter [BL-069](#) provides additional information on loan origination, disbursement, and payment controls.
- Delegated Lending Authorities (DLA): Does management's system of internal controls include reasonable DLAs to control loan and credit action approvals?** FCA Regulation [614.4150\(e\)](#) requires the institution to maintain guidance on loan approval delegations. The use of DLAs, including the use of loan committees and funding bank approvals, provides a mechanism that controls loan decisions. Complacency with DLAs can allow opportunities for inappropriate behavior or fraud. Approval authority levels should be set and periodically updated based on experience, expertise, and performance of lending personnel in relation to the risk that loans present to an institution's capital and earnings. To evaluate the adequacy of current DLAs, the institution might track the quality and performance of loans approved within an individual's DLA as well as internal credit review grades, if assigned. More restrictive delegations are common for higher-risk credit actions, such as loans with less favorable risk ratings (Probability of Default or Loss Given Default) or underwriting exceptions, unsecured loans, newer lending programs, project or construction financing, loans to specialized industries or with specialized collateral, out-of-territory loans, etc. DLAs should be set based on total customer attributed commitment and not just individual loan size. There should also be controls in place to ensure all loan transactions that exceed DLAs are identified and go through appropriate approval channels. Once a loan is approved, controls should be in place to ensure that any material modifications require reauthorization through the appropriate approval channels. Likewise, controls should ensure funding bank approvals are obtained when required per FCA Regulations [614.4460](#) and [614.4470](#). FCA Bookletter [BL-069](#) provides additional information on ensuring proper use of DLAs.



- **Loan Committees: Does the Loan Committee serve as an effective control to ensure sound credit decisions on significant loan exposures? Does the committee function reinforce a commitment to sound credit administration?** Loan committees should ensure the loans they review or approve reflect prudent credit decisions and credit administration practices that adhere to the institution's guidance. If the Loan Committee approves loans with credit administration weaknesses, it makes enforcing the institution's credit guidance more difficult. Loan committees are usually comprised of the institution's most competent and experienced lending staff, who should set the tone regarding credit administration expectations. Committee meetings should occur with enough frequency to ensure timely loan review and approval, as well as timely feedback to lending staff. In addition, Loan Committee practices should ensure involvement early and often in the loan making and servicing processes. Loan Committee approvals should be adequately documented, with evidence in loan files that committee input and any conditions of approval were appropriately addressed.
- **Staff Training and Expertise: Do staff have the necessary training and expertise to adequately administer credit?** Management should ensure lending staff have the knowledge and tools to make and service loans in accordance with the institution's credit administration expectations. In addition to highly trained lending staff, management should ensure staff performing back-office functions, such as loan documentation, are trained to understand their roles within the framework of strong credit administration. The institution should ensure cross-training and contingency planning are in place, so it is not overly reliant on a single employee to handle critical components of credit administration.
- **Management Review and Supervision: Does management review the effectiveness of the credit controls noted above and monitor and hold staff accountable for adherence to credit administration guidance?** Management needs to periodically review credit controls to ensure they remain effective as conditions and operations change. In addition, management should have processes to review employee adherence to credit administration guidance apart from the independent internal credit review function. Systems should be in place to oversee credit staff's work and ensure desired results are achieved. This includes ensuring credit staff are making sound lending decisions and adhering to control processes. Review and supervision of loan origination, disbursements, and payments are critical. Daily closing routines can serve as an opportunity to identify irregular transactions or exceptions to internal control processes. Daily closing routines should be documented and create a sufficient audit trail for management (and auditors) to review. Monthly and quarterly close-out activities can provide another opportunity to review trends in activities for anomalies suggesting control issues, personnel issues (i.e., sloppiness, lots of errors), or simply issues with association procedures. As a sound practice, institutions should require all employees take a minimum number of vacations days so account administration and control processes can be handled by different employees for a given period. The institution should also consider how to tie credit administration results to performance evaluations and compensation. Incentive plans and the performance appraisal process can have a significant effect on adherence to credit guidance and direction if administered appropriately. Refer to the *Employee Compensation and Performance Standards & Evaluations* procedures in the *Human Capital Management Examination Manual* topic for more detailed guidance on examining these areas.

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

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

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

#### Guidance:

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

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

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

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

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

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

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

- **Scope and Depth: Are audit or review scope and depth sufficient to conclude on the adequacy, completeness, and timeliness of credit administration processes?** The scope 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). Audit or review workpapers should be examined 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 plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and didn't include reviewing other controls, such as training or reporting, or testing compliance with regulations or institution guidance. If the work deviated materially from the original planned scope, internal audit should notify the board (or Audit Committee, if so delegated) of the reasons for the change. Specific items that should be considered in the audit or review scope include:
  - Credit administration policies and procedures, including capital markets and scorecard lending programs, if applicable.
  - Compliance with credit administration policies, procedures, FCA Regulations, and other FCA guidance.
  - Monitoring and control processes (e.g., reporting, management oversight, delegated authorities, separation of duties, management information systems and data).
  - Sufficient transaction testing to evaluate the major credit administration areas (e.g., credit analysis and decision, loan terms and conditions, loan and legal documents, financial information, loan servicing, disbursement/payment controls, delegated lending authorities, eligibility and authorities, loan underwriting standards, due diligence on purchased loans).
  - Management of all significant credit analysis and scoring models, including consistency with the institution's overall model risk management framework.
  - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.
- **Loan Sampling: Was an appropriate loan sampling process used?** It is important to understand how the loan sample was selected to determine if relevant information was considered. The loan sampling methodology should evidence appropriate use of data tools to be consistent with population size and target specific risk factors. For example, a loan sample may be based on specific loan attributes (e.g., size, risk rating, commodity, region, loan product, lending program) or other factors such as commodity specific adversity,

changes in lending staff, or previously identified credit administration weaknesses. If a loan sample is targeted to test specific internal controls related to credit administration, that should be specified and supported. The loan sample methodology should be clearly documented and reported. In addition, loan sampling processes should consider periodic, branch or regional audits and reviews, including review of some loan transactions without advance notice.

- **Reliability of Results: Did FCA identify any concerns with audit or review reliability?** It is important to understand the scope and depth of the audit or 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 review results:
  - *FCA Testing* – Evaluate the reliability of internal audit or review work by comparing the results to FCA’s examination results in this area. This comparison often includes FCA testing transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. This can be especially important if the audit or review report is not sufficiently detailed or FCA’s examination work and testing identifies potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant audit evidence when conducting and supporting their work. (IIA Standards 2240, 2300, 2310, and 2320) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or review, the cause for any discrepancy should be determined.
  - *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, skills, and other competencies needed to perform the work. (IIA Standard 2230) 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 1100, 1112, 1120, and 1130) For example, audit and review staff should not be involved in developing and installing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. Examiners should evaluate the 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 the workpapers to ensure audit or review objectives and scope were met and the results and conclusions were reliable and supported. (IIA Standard 2340) Examples could include a supervisory review of in-house audit work by the CAE or other audit staff, or a review of outsourced work by the CAE or audit coordinator. 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 review report sufficiently communicate credit administration review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:
  - Is the report prepared 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 2330, 2400, 2410, 2420, 2440, and 2450)
  - Are conclusions and recommendations realistic and reasonable, with material and higher risk issues clearly identified and prioritized?
  - Are conclusions and recommendations supported by convincing evidence, persuasive arguments (condition, criteria, cause, and effect), and adequate workpaper documentation on individual assets reviewed?
  - Do results in the workpapers align with report conclusions?
  - Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?
  - Does the report address potential vulnerabilities to fraud, if applicable?
- **Corrective Action: Are management responses to audit or review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management commitments and agreements or any areas of disagreement should be documented in the report or in a separate memo or tracking system. (IIA Standards 2500 and 2600) 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 did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

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

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

##### Guidance:

Loans and loan-related assets are examined, in part, to determine if the institution is administering credit in a safe and sound manner and in compliance with regulatory guidance. This includes determining if credit administration policies, procedures, and internal controls are working as

intended and producing the desired results. As such, FCA's transaction testing is a critical part of the overall evaluation of an institution's credit administration processes. Some specific areas considered for examination in credit administration transaction testing include the following:

- Credit analysis and decision
- Loan terms and conditions
- Loan and legal documents
- Financial information
- Loan servicing
- Disbursement/payment controls
- Delegated lending authorities
- Eligibility and authorities
- Due diligence on purchased loans

**Selecting the Examination Focus Areas and Loan Sample:** The extent and focus of credit administration testing on individual loans should depend in part on the conclusions reached when completing the various *Credit Administration* examination procedures. If examination results indicate the institution has adequate credit guidance and effective internal controls (including independent internal credit review coverage and reliability) in place to ensure sound credit administration practices, limited testing of individual loans to verify these conclusions may be all that is necessary. The loan sample may need to be expanded if examiners identify weaknesses in lending guidance or control processes, or transaction testing results indicate that policies, procedures, and controls are not being followed, functioning as intended, or achieving the desired results. Alternatively, if conditions warrant, we may ask the institution to complete an independent review to fully test whether controls are working as intended. To determine the appropriate sample size for testing the institution's credit administration processes, examiners should also consider the following factors:

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

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

After identifying credit administration areas to test, examiners will need to select the loan sample. Examiners should select the types of loans that will enable them to effectively conclude on the areas being tested. For example, you would typically select new loans or loans with recent credit actions to

test areas such as credit analysis and decision, financial information, or delegated lending authorities. Loan servicing can be tested on a wide range of loans but is especially important on loans that have a criticized classification, past due loans, and loans in distressed industries (including large loans that are classified Acceptable but are experiencing stress).

*Direct Loan Considerations (banks only):* A sample of direct loans classified Acceptable, Special Mention, and Adverse should be considered in the examination scope. Depending on the number of other financing institutions (OFIs) in the district, a sample or all OFI direct loans should be included. Additionally, participation interests purchased in direct loans should be included, if applicable.

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

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

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

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

###### Guidance:

Farm Credit banks (banks) need to implement policies, procedures, and controls for administering direct loans to associations and OFIs. Consistent with the extension of any credit, the banks are required to evaluate the creditworthiness of each of their affiliated associations and OFIs. Therefore, each bank should ensure its credit administration guidance and practices are sufficient to identify and manage the risk presented by the associations and OFIs it finances. Much like loans to retail borrowers, the bank should structure direct loans with appropriate terms and conditions that

mitigate the key risks in the lending relationship. These terms and conditions should be outlined in the general financing agreement (GFA) or the related promissory note. Ongoing monitoring and servicing of these loans should be reflective of the lender's risk profile, with more extensive oversight and communication as the risk profile increases. Guidance should also govern how the bank will exercise its supervisory responsibilities over associations. The bank will typically administer most of these responsibilities through the GFA, but there are other administrative responsibilities that banks must fulfill to meet specific regulatory requirements and the Farm Credit Act of 1971, as amended (the Act). Banks are also tasked with oversight of the associations' ICFR to help ensure reliability of System financial reporting. Each bank should have processes in place to ensure associations and OFIs are complying with their respective policies and procedures as well as laws and regulations.

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

- ***Policies and Procedures: Does the bank maintain appropriate lending policies and procedures specific to administering direct loans to associations and OFIs?*** FCA Regulation [614.4120](#) requires the board of each bank to adopt policies and procedures governing extension of credit to associations and OFIs. In addition to the specific requirements identified in the regulation, effective policies and procedures should address items such as the underwriting, monitoring, and servicing of direct loans, similar to credit administration guidance for the retail portfolio. The following addresses several specific considerations and requirements for bank guidance:
  - Does guidance ensure that direct loans are extended through a GFA as required by FCA Regulations [614.4125](#) (associations) and [614.4130](#) (OFIs)? Refer to the regulations for specific requirements related to GFAs.
  - Do policies and procedures prescribe sufficient guidance to determine the lender's creditworthiness? The bank should have comparable and objective loan underwriting standards and pricing requirements for OFIs and associations. The bank should consider risk factors such as adherence to capital requirements, repayment ability, asset quality, liquidity, quality of collateral, business plan objectives, and quality of board and management.
  - Has guidance been established to ensure appropriate loan servicing? Servicing should be reflective of the borrower's risk profile, with the expectation for more extensive oversight and communication as the risk profile increases. The bank should develop loan servicing plans identifying strategies for higher risk or adverse direct loans to mitigate the risk of loss. Bank guidance should also address the FCA and Farm Credit System Insurance Corporation notifications and consents required by FCA Regulations [614.4125\(e-g\)](#) related to administering loans to associations.
  - Does guidance address the bank's supervisory role and oversight responsibilities? Guidance should include board policies that clearly reflect the bank's supervisory responsibilities and the board's expectations of management in carrying these out. This would include the board's expectations for administering the general supervisory relationship over affiliated associations provided for in section [1.5 \(13\)](#)



of the Act. The Act and regulations also require bank approval of, authorization of, or other involvement in specific association activities and operations. Policies and procedures should reflect these specific responsibilities and be sufficient to ensure ongoing compliance with regulatory requirements.

- Does guidance for OFI lending address compliance with FCA Regulations in Part 614, subpart P? Guidance should address:
  - Criteria and eligibility requirements for OFIs to have access to funding, discount, or similar financial assistance from a funding bank as required by FCA Regulations [614.4540](#) and [614.4560](#). In addition to specific policy, procedure, pricing, and loan underwriting standard requirements in FCA Regulation [614.4540\(c\)](#), these regulations identify numerous other requirements for administering credit to OFIs that should be addressed in the bank's guidance.
  - Requirements in FCA Regulation [614.4570\(c\)\(1\)](#) related to supplemental collateral or other credit enhancements for OFIs. Guidance should also address other collateral requirements as well as recourse and guarantee expectations for OFIs to ensure compliance with FCA Regulation [614.4570](#).
  - Limitations on the amount of financing provided to OFIs in relation to capital, as prescribed by FCA Regulation [614.4580](#).
  - Equitable treatment of OFIs and associations regarding underwriting standards, interest rates, fees, and capitalization requirements, as required by FCA Regulation [614.4590](#).
- **Internal Controls: Does the bank have sufficient internal control processes in place to ensure compliance with its guidance for administering direct loans?** The bank should have controls such as segregation of duties, delegated lending authorities, loan committees, staff training, and management supervision to ensure direct loan administration guidance is implemented as intended. This should also include internal audit and review coverage to evaluate the bank's direct loan administration guidance, processes, and controls to ensure they are functioning as intended. Additionally, given the importance of the GFAs, the bank should implement a review process to ensure all legal documents, including the GFA, note, and collateral instruments, are legally executed and perfected.
- **Direct Loan Monitoring: Is the bank effectively monitoring risk by routinely evaluating association and OFI financial condition and compliance with the GFA?** The bank should monitor compliance with loan terms and conditions, which are outlined in the GFAs. While GFAs can have up to a 5-year term, the bank should complete at least an annual review of each direct loan to ensure timely risk identification and servicing. The frequency and depth of monitoring direct loans, including compliance with GFAs, should be commensurate with risk exposure and comply with bank loan servicing guidance. Ongoing monitoring practices typically include various reports on the direct loan portfolio, including key credit and financial performance measures and covenants, GFA compliance, liquidity, audit results, and overall financial condition changes. The frequency of reports to the board may need to increase for higher-risk or deteriorating direct loans. As part of monitoring, the bank should also have processes to validate the quality of assets securing the direct loans. Specific to

associations, the bank should also validate that ICFR meet the requirements in the GFAs. The following questions elaborate on these control processes:

- *Collateral Monitoring* – Does the bank have a process to ensure that associations and OFIs have adequate risk identification and credit administration? The bank should validate each lender’s risk identification and credit administration to ensure asset quality and collateral risk are adequately reported and monitored. Since System institutions are required by FCA Regulation [618.8430\(c\)](#) to have an asset review program, the bank should also compare its results to those from each association’s review activities to ensure the associations’ audit and review functions are reliable. The bank should also ensure that association long-term mortgage loans meet the first lien requirements in FCA Regulation [615.5060\(a\)](#). If an association cannot provide proof of a perfected first lien position within 1 year of loan origination, the loan must be removed from collateral for the direct loan.
- *ICFR Oversight* – Does the bank evaluate each association’s ICFR program to ensure compliance with the GFA ICFR covenant? While each association is responsible for evaluating the design and effectiveness of its ICFR, the bank’s program level review should ensure alignment with stated expectations in support of the combined System financial statements. The adequacy of an association’s ICFR program could potentially impact System disclosures, so the bank should ensure its associations have implemented ICFR programs in line with the agreed upon framework established by the Federal Farm Credit Banks Funding Corporation. This should include reviewing each affiliated association’s ICFR program design and processes with such scope and frequency as the bank determines, considering whether the association obtains an integrated audit opinion (entities that receive an integrated audit may not be subject to the bank’s GFA ICFR program review). The bank should review documentation that supports how controls operate, the testing process, and the reporting and timely remediation of any deficiencies. The bank should also review the Summary of Aggregate Deficiencies (SAD) report from its associations. The bank should ensure associations have timely and effective action plans to address reported weaknesses or deficiencies. Material weaknesses and significant deficiencies could potentially impact financial reporting at the bank and System level.

## **Examination Procedures and Guidance**

### **Regulatory Compliance**

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

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

#### **Guidance:**

System banks, associations, and the Farm Credit Leasing Services Corporation must comply with eligibility and scope of financing regulations outlined in FCA Regulations Part 613. Under the lending authorities in Title I and II of the Act, institutions are authorized to provide credit (including leases) to bona fide farmers, ranchers, and producers or harvesters of aquatic products (bona fide farmers). In addition to meeting agricultural needs, the scope of financing allowed includes processing and

marketing activities directly related to the borrower's agricultural or aquatic operations and non-agricultural needs (both are referred to as *other credit needs*). Institutions with Title I and II authorities are also authorized to finance farm-related service businesses and rural homes when certain eligibility and scope of financing criteria are met. A bank operating under Title III of the Act has authority to lend to eligible: (1) producer, supply, or business service cooperatives that eligible agricultural and aquatic producers own and control; (2) parents, subsidiaries, and affiliates of such cooperatives; (3) rural electric and telecommunication utilities; and (4) water and waste disposal facilities that operate in rural areas with populations of 20,000 or fewer inhabitants within a state. Title III also provides banks with authority to finance the import and export of agricultural and aquatic commodities, products, and capital equipment, as well as international business operations (of eligible borrowers). Banks, associations, and the Farm Credit Leasing Services Corporation should have policies, procedures, and control mechanisms to ensure compliance with applicable eligibility and scope of financing regulations.

Note: Guidance for examining eligibility and scope of financing issues on loan and lease participation purchases is addressed in the *Loan Purchases & Sales* procedure.

Evaluative questions and items to consider when examining compliance with regulatory requirements related to eligibility and scope of financing include:

- ***Bona Fide Farmers: Does guidance adequately address eligibility and scope of financing for loans to bona fide farmers?*** Policies and procedures should address board and management expectations and regulatory requirements for eligibility and scope of financing on loans to bona fide farmers. An eligible borrower is a person or legal entity that meets the definitions in FCA Regulation [613.3000](#). Eligible borrowers may seek financing for agricultural and other credit needs. FCA Regulation [613.3005](#) requires that loans shall be on an increasingly conservative basis as the emphasis moves away from the full-time farmer to the point where only agricultural needs will be financed for the applicant whose business is essentially other than farming. When financing involves real estate, refer to the agricultural land definition in FCA Regulation [619.9025](#). Credit should not be extended for investment in agricultural assets when speculative appreciation is a primary factor. Note: Leases are subject to the same eligibility and scope of financing requirements as loans (refer to FCA Bookletter [BL-020](#)). Guidance on lending to bona fide farmers should also address the following items, as applicable:
  - *Extent of Farm Involvement* – The Act and FCA regulations do not prescribe specific criteria for identifying a full-time versus less-than full-time farmer. It is important that the board and management establish reasonable, objective, and sound criteria that serves the territory and aligns with the institution's risk-bearing ability. Refer to FCA Examination Bulletin [2006-2](#) for considerations in determining agricultural involvement.
  - *Non-Agricultural Lending* – Policies and procedures should define the objective and scope of lending for non-agricultural purposes. The principal objective should be to provide financing necessary to ensure full-time farmers receive sound and constructive credit to support their full needs, and that part-time farmers are provided appropriate financing to allow them to remain in agriculture. Under FCA Regulation [613.3005](#), institutions can provide full credit for family needs (including housing) to both full-time and less-than full-time farmers. If a borrower is less than a full-time farmer, the institution needs to determine to what extent that borrower qualifies for other credit needs. FCA Examination Bulletin [2006-2](#) discusses key

considerations for determining if the financing request is reasonable in relation to current or planned agricultural activities and if the purpose of the loan supports the borrower's ability to remain in farming and in a rural area. In addition, FCA Bookletter [BL-040 REVISED](#) encourages institutions to develop different criteria for determining the amount of other credit needs financing available to young, beginning, and small (YBS) farmers. Such criteria should take into consideration the degree to which a YBS farmer is engaged, or intends to be engaged, in agricultural production. Additional considerations for financing the credit needs of farmers operating in local or regional food systems (who often qualify as YBS farmers) can be found in FCA Bookletter [BL-066](#).

- *Legal Entities* – Legal entities (i.e., partnerships, corporations, estates, or trusts) are eligible for financing on the same basis as individuals if the entity meets the definition in FCA Regulation [613.3000\(a\)\(2\)](#) and the eligibility requirements discussed above. The institution needs to support the eligibility determination of a legal entity on a stand-alone basis, separate from the eligibility of the individuals that may own the legal entity. Refer to FCA Bookletter [BL-059](#) for answers to frequently asked questions about eligibility and scope of financing for limited liability companies.
- *Land in Transition* – FCA defines land in transition as agricultural land that lies in the path of development. If engaged in this type of real estate lending, the board should develop a policy defining permissible situations for land in transition financing and establish controls such as loan-to-value limits, concentration parameters, and audit coverage to address the unique risks. As stated in FCA Examination Bulletin [2009-2](#), institutions are responsible for ensuring that proposed financing of agricultural land in transition is safe, sound, and permissible. In addition, FCA Bookletter [BL-058](#) provides evaluative questions for institutions to consider when financing land in transition.
- ***Rural Home Loans: Does guidance adequately address eligibility and scope of financing for rural home loans?*** As addressed in FCA Regulation [613.3030](#), Title I and II direct lenders can make rural home loans to individuals who are not bona fide farmers. A rural home loan must be for a single-family, moderately priced dwelling in a rural area where the population does not exceed 2,500 inhabitants. The home must be the borrower's primary residence, and no borrower is allowed to have a loan from the System on more than one rural home at a time. The scope of financing for such loans only permits an eligible borrower to purchase, build, remodel, repair, improve, or refinance a rural home. Institutions that provide rural home loans should have guidance to ensure compliance with FCA Regulation [613.3030](#). Refer to the *Concentration Risk Management* Examination Manual topic for examining compliance with the rural home portfolio limits in this regulation.
- ***Farm-Related Service Businesses: Does guidance adequately address eligibility and scope of financing for loans to farm-related service businesses?*** Title I and II direct lenders can provide financing for farm-related service businesses, as addressed in FCA Regulation [613.3020](#). The regulation identifies specific requirements for scope of financing based on whether the farm-related service business derives more than 50 percent of its income from furnishing farm-related services that are directly related to agricultural production. For example, businesses that offer non-agricultural services to farmers and ranchers, such as real estate agents, do not qualify as eligible farm-related businesses. Under Title I

authorities, mortgage lenders may make loans to eligible farm-related service businesses for acquiring real estate, building facilities, and financing necessary capital structures, equipment, and initial working capital. Institutions that provide loans to farm-related service businesses should have guidance to address eligibility and scope of financing requirements.

- ***Processing or Marketing Operations: Does guidance adequately address eligibility and scope of financing for loans to processing or marketing operations?*** Institutions can finance processing or marketing facilities, depending on the level of ownership, control, or throughput provided by a bona fide farmer as described in FCA Regulation [613.3010](#). Institutions that make processing or marketing loans must have a board policy that addresses eligibility and other requirements in FCA Regulation [613.3010\(d\)](#). These requirements include developing and implementing procedures that address the specific items described in the regulation. Refer to the *Concentration Risk Management* Examination Manual topic for examining compliance with the portfolio limits in this regulation.
- ***Agricultural Cooperatives, Rural Infrastructure, and Other Eligible Entities (for banks operating under Title III): Does guidance adequately address eligibility and scope of financing for these types of domestic lending under Title III?*** An agricultural credit bank (ACB) should have lending guidance that outlines the unique eligibility and scope of financing requirements for domestic lending under Title III authority and FCA Regulation [613.3100](#). Cooperatives of farmers, ranchers, and aquatic producers and harvesters that satisfy certain criteria, and their parents, subsidiaries, affiliates, and benevolent organizations, are eligible for loans from an ACB under Title III. An ACB is also authorized to lend to rural electric and telecommunications utilities, including cable television utilities, and to water and waste disposal facilities. Lending to eligible entities for water and waste disposal facilities must be solely for installing, maintaining, expanding, improving, or operating such facilities in rural areas where the population does not exceed 20,000 inhabitants.
- ***International Lending (for banks operating under Title III): Does guidance adequately address eligibility and scope of financing for international lending?*** An ACB may provide financing to eligible cooperatives and certain other entities for the import and export of agricultural commodities and supplies under Title III authority and FCA Regulation [613.3200](#). An ACB may also lend to domestic or foreign entities that are at least partially owned by eligible cooperatives and that facilitate the international business operations of such cooperatives. Board policy guidance should address the requirements in this regulation, including the requirement in FCA Regulation [613.3200\(c\)](#) for the board to adopt policies that ensure priority is given to eligible cooperatives for export financing.
- ***Similar Entities: Does guidance adequately address eligibility and scope of financing for similar entity lending?*** FCA Regulation [613.3300](#) addresses similar entity authorities and requirements. It defines a similar entity as a party that is ineligible for a loan from a System institution but has operations that are functionally similar to the activities of eligible borrowers in that a majority of its income is derived from, or a majority of its assets are invested in, the conduct of activities that are performed by eligible borrowers. Banks and associations may participate with non-System lenders in loans to similar entities. Participation in these multi-lender transactions is defined differently than for eligible borrowers (see Section [3.1\(11\)\(B\)\(iii\)](#) of the Act). Although similar entities are not eligible borrowers, the loan must be for a purpose authorized under Titles I, II, or III. This regulation also applies to interests in leases to similar entities (see FCA Regulation [616.6100\(f\)](#)). As

discussed in FCA Bookletter [BL-067](#), institutions should ensure that appropriate policies, procedures, and internal controls are in place for similar entity lending. Refer to the Bookletter for specific considerations. FCA's [FAQS about Similar Entity Reporting](#) contain additional guidance on similar entity authorities and related reporting to FCA. Guidance and controls over similar entity lending are especially important as this type of lending can potentially expose the institution to significant reputation risk and scrutiny from the public, Congress, and FCA. Refer to the *Concentration Risk Management* Examination Manual topic for examining compliance with the lending and portfolio limits in FCA Regulation [613.3300\(c\)](#).

- ***Board and Management Oversight: Do the board and management provide adequate oversight of eligibility and scoping of financing activities?*** The board and management should periodically review eligibility and scope of financing policies, procedures, controls, and activities to ensure continued compliance with regulatory requirements and alignment with the board's philosophy. The board and management should also consider their risk appetite and the needs of the customer base when making decisions on lending for other credit needs, land in transition, and similar entities as these types of loans may pose additional credit and reputation risks.
- ***Documentation and Approval: Does the institution require sufficient documentation and support for eligibility and scope of financing determinations as part of the credit analysis and approval process?*** Guidance and controls need to ensure that eligibility and scope of financing are evaluated and documented as part of each loan decision. When eligibility and scope of financing determinations are complex, (e.g., when lending for other credit needs, processing or marketing operations, farm-related service businesses, or similar entities) a formal legal opinion may be prudent. The documentation and approval process should also include steps to accurately designate loan type and loan purpose so management can identify and monitor loans made through different eligibility authorities.
- ***Training and Communications: Do training and other communication processes enable staff to understand and apply the eligibility and scope of financing regulatory requirements and related institution guidance?*** Periodic training should ensure that staff understand regulatory requirements and the institution's guidance in these areas. Processes should ensure changes to policies, procedures, or other controls are timely communicated to staff.
- ***Other Internal Controls: Are other internal controls sufficient to ensure eligibility and scope of financing are handled in compliance with policies, procedures, and regulatory requirements?*** In addition to written guidance, documentation and approval processes, and training, the institution should consider other controls such as delegated lending authorities, management review and supervision, standardized forms, and checklists to ensure compliance with policies, procedures, and regulatory requirements. These controls are important to ensure loan data is accurately reported internally and to FCA. Additionally, the independent internal credit review function should provide adequate coverage of eligibility and scope of financing. Refer to the *Audit/Review* procedure for examining eligibility and scope of financing compliance audits. Refer to the *Transaction Testing* procedure for evaluating compliance with eligibility and scope of financing requirements during FCA loan examinations to determine if internal controls are functioning effectively.

## 2. Lending Authorities & Territories:

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

### Guidance:

The System's lending authorities are divided into three titles as defined in the Act:

- *Title I* – Long-term real estate lending authorities granted to the Farm Credit banks (FCBs) and agricultural credit banks (ACBs). The banks transferred these lending authorities to its affiliated federal land credit associations (FLCAs) and agricultural credit associations (ACAs). The banks, however, retain residual authority to make mortgage loans directly to eligible borrowers in geographic areas where no association operates. Additionally, Title I authorizes FCBs and ACBs to fund and discount loans for direct-lender associations and other financing institutions (OFIs).
- *Title II* – Short- and intermediate-term lending authorities granted to production credit associations (PCAs) and ACAs.
- *Title III* – Lending authorities granted to ACBs and FCBs for cooperatives to make or participate in loans to eligible cooperatives and their parents, subsidiaries, and affiliates for both domestic and international financing, as well as rural utilities and water and waste facilities.

In addition to its lending authorities, each institution has a federally chartered territory. An institution's primary mission should be to serve the eligible, creditworthy customers within its chartered territory. Institutions operating under Titles I or II that provide lending services to borrowers outside its territory need to coordinate such activities with other institutions as required by FCA Regulation [614.4070](#). Institutions should have policies, procedures, and control mechanisms to ensure compliance with lending authority and chartered territory regulations.

Evaluative questions and items to consider when examining compliance with lending authority and chartered territory requirements include:

- **Lending Authorities: Does guidance adequately address the institution's lending authorities?** Policies, procedures, or other guidance should ensure that loans are made under the appropriate lending authorities. The following summarizes lending authorities based on entity type:
  - FLCAs are authorized to make real estate mortgage loans with maturities of not less than 5 years or more than 40 years as addressed in FCA Regulation [614.4030\(a\)](#).
  - PCAs are authorized to make or guarantee short- and intermediate-term loans that mature within 10 years as authorized by their funding banks (15 years for producers and harvesters of aquatic products), as addressed in FCA Regulation [614.4040\(a\)](#).
  - Most associations operate under an ACA parent structure that includes FLCA and PCA subsidiaries, which better enables it to exercise its authority to make short-, intermediate-, and long-term real estate loans in accordance with FCA Regulation [614.4050\(a\)](#).

- FCBs are authorized to make loans and extend credit to associations and OFIs as addressed in FCA Regulations [614.4000\(b\) and \(c\)](#). The stated term of a general financing agreement cannot exceed 5 years, but it may automatically renew for additional terms of 5 years if neither party objects at the time of renewal. See FCA Regulation [614.4120](#).
- ACBs are authorized to make the same loans and extensions of credit as an FCB, as addressed in FCA Regulations [614.4010\(b\) and \(c\)](#). In addition, FCA Regulation [614.4010\(d\)](#) addresses ACB authority to extend credit to (or on behalf of): (1) eligible cooperatives, including their parents, subsidiaries, affiliates, and benevolent organizations, (2) rural utilities, (3) water and waste disposal facilities, and (4) domestic lessors. This includes loans to cooperatives and other eligible entities for international trade. Refer to FCA Regulations [614.4232](#), [614.4233](#), and Part 614 Subpart Q, and Section [3.7](#) of the Act, for additional details. These regulations and the Act contain several requirements for board policies if the ACB exercises these authorities.
- Banks and associations are authorized to enter into agreements with agents, dealers, cooperatives, other lenders, and individuals to facilitate making loans to eligible borrowers. Institutions that enter such agreements must establish a board policy to ensure compliance with the requirements in FCA Regulation [614.4525](#).
- PCAs and ACAs are authorized to make special types of loans on commodities covered by price support programs. FCA Regulation [614.4530](#) requires that these loans be made under policies and procedures developed and approved by the funding bank.
- Banks and associations have authority to purchase and sell participations and other interests in loans as discussed in the *Loan Purchases & Sales* procedure.
- **Leasing Authorities: Does guidance adequately address the institution's leasing authorities?** If the institution engages in leasing activities, then policies, procedures, or other guidance must address leasing authorities. ACAs have authority to make both long-term facility and short- and intermediate-term equipment leases, while FLCAs are only authorized to make long-term facility leases. Guidance should also address FCA Regulation [616.6400](#), which requires the institution to document that any asset it leases is within its statutory authority. Note: Leasing policies and procedures required by FCA Regulation [616.6300](#) are examined in the *Credit Administration Guidance & Standards* procedure.
- **Out-of-Territory Lending: Does guidance adequately address out-of-territory lending requirements?** Policies, procedures, or other guidance for institutions that conduct out-of-territory Title I or II lending should address compliance with FCA Regulation [614.4070](#). Refer to the regulation for specific requirements, which are based on where the borrower's headquarters and the operations being financed are located. This determines whether the institution needs to provide notice to, or obtain concurrence from, other System institutions providing similar credit in the territory(ies) in which the operations being financed are conducted. If the institution finances borrowers whose operations are conducted wholly outside the institution's chartered territory, such loans must be authorized by a board policy and must not constitute a significant shift in loan volume away from the institution's assigned territory. The institution must identify loans that finance eligible borrower



operations conducted wholly outside its territory and monitor the number and volume of these loans as required by FCA Regulation [614.4070\(c\)\(2\)](#). Note: Under FCA Regulation [616.6200](#), institutions may make leases outside of their chartered territories without complying with the notice or concurrence requirements in FCA Regulation [614.4070](#).

- **Board and Management Oversight: Do the board and management provide adequate oversight of how the institution uses its lending authorities and conducts out-of-territory lending?** The board and management should periodically review lending authority and out-of-territory lending policies, procedures, controls, and activities to ensure continued compliance with regulatory requirements and alignment with the board's philosophy.
- **Training and Communications: Do training and other communication processes enable staff to understand and apply the lending authority and territorial regulatory requirements and related institution guidance?** Periodic training should ensure that staff are familiar with regulatory requirements and the institution's guidance in these areas. Processes should ensure changes to policies, procedures, or other controls are timely communicated to staff.
- **Other Internal Controls: Are other internal controls sufficient to ensure lending authorities and out-of-territory lending are handled in compliance with policies, procedures, and regulatory requirements?** In addition to written guidance and training, the institution should consider other controls such as delegated lending authorities, management review and supervision, standardized forms, and checklists to ensure compliance with policies, procedures, and regulatory requirements. These controls are important to ensure loan data is accurately reported internally and to FCA. Additionally, the independent internal credit review function should provide adequate coverage of lending authorities and out-of-territory lending. Refer to the *Audit/Review* procedure for examining lending authorities and territory compliance audits. Refer to the *Transaction Testing* procedure for evaluating compliance with lending authority and out-of-territory lending requirements during FCA loan examinations to determine if internal controls are functioning effectively.

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

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

#### Guidance:

Institutions can purchase and sell participation interests as well as other interests in loans and leases based on their specific lending authorities, as described in FCA Regulation 614 Subpart A. Under the Act, System institutions have the authority to participate in loans with System and non-System lenders. A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead institution or lender originates the loan and sells ownership interests (up to 100 percent) to one or more participating institutions at the time the loan is closed. The lead (originating) lender typically retains a partial interest in the loan, is the only lender of record, services the loan, and deals directly with the customer for the benefit of all participants. Loan participations are distinct from partial and whole loan purchases. The distinction centers around who retains the legal relationship with the borrower. A participation relationship is between the originating lender and the purchasing institution and not between the purchasing institution and the borrower. Loan participations are the most common way System institutions engage in multi-lender transactions. However, any type of loan purchase or sale must comply with

FCA Regulations 614 Subpart H. Syndications, which are another way of providing multi-lender financing with other System and non-System institutions, are treated as direct loans because several lenders are signatories on the loan agreement with the borrower. FCA's Informational

Memorandum on [Loan Syndication Authorities for Banks and Associations](#) dated February 24, 2004, provides guidance on the authority to engage in loan syndication transactions.

Loan purchases and sales can play a significant role in an institution's portfolio management practices. Through loan purchases, institutions can spur loan growth, diversify the portfolio by industry and geographic region, increase cooperation with other System institutions, and invest in large loans without servicing or origination costs. Through loan sales, institutions can maintain compliance with internal and legal lending limits, reduce concentration risk, and manage capital. However, loan purchases and sales can create unique challenges and risks, such as credit risk which can result from inadequate industry knowledge or overreliance on the selling institution's analysis. Other examples include reputation risk, litigation or put-back risk that can result from inadequate participation agreements, deficient loan servicing practices, or other issues with counterparties. Additionally, loan purchases should not be relied on to the point where they impede the institution's ability to serve eligible, creditworthy customers in their chartered territory. Institutions should have policies, procedures, and control mechanisms to manage these unique challenges and risks and ensure compliance with loan purchases and sales regulations.

Evaluative questions and items to consider when examining compliance with regulatory requirements for loan purchases and sales include:

- ***Loan Purchase and Sales Guidance: Does the institution have sufficient guidance to administer loan purchases and sales and ensure regulatory compliance?*** FCA regulations include various requirements for policies, lending authorities, and credit analysis for loan and lease purchases and sales.
  - *Policy Requirements* – FCA Regulations [614.4325\(c\)](#) (loans) and [616.6100\(b\)](#) (leases) require the board to adopt policies on exercising the institution's authority to purchase or sell interests in loans and leases. In particular, policies must address the types of loans and leases an institution may purchase and sell as well as the underwriting requirements and due diligence processes. The board must outline any portfolio limits as well as processes for identifying and reporting loan and lease purchases and sales. Policies or procedures should also address requirements in FCA Regulations [614.4325\(g\) and \(h\)](#) on sales with recourse and performing transactions through agents, if applicable. Refer to the regulations for additional specific matters that must be addressed in policies.
  - *Lending Authorities* – Guidance should ensure interests in loans and leases may only be sold in accordance with each institution's lending authorities as described in FCA Regulation [614.4325\(b\)](#) (loans) and [616.6100\(a\)](#) (leases). An institution may purchase a participation interest in a loan that another System institution makes under Titles I, II, or III of the Act, in accordance with FCA Regulations in Part 614 Subpart A. Institutions may only purchase participation interests in loans that it is authorized to make from non-System lenders. Policies or procedures should ensure loans participated between or among System institutions meet the borrower eligibility, membership, loan term, loan amount, loan security, and stock purchase requirements of the originating lender as outlined in FCA Regulation [614.4330\(b\)](#).

- *Independent Credit Analysis* – Effective guidance should ensure appropriate due diligence and full understanding of the risks present in loan or lease assets being purchased, which includes addressing the independent judgment requirements in FCA Regulations [614.4325\(e\)](#) (loans) and [616.6100\(d\)](#) (leases). Institutions are required to complete an independent analysis to comply with these regulations but may rely on System risk-rating guidance or other industry standards (e.g., a credit rating agency’s standards) to validate the credit analysis completed by the originating institution. As discussed in FCA Bookletter [BL-027](#), the independent credit decision requirement applies to purchasing individual loans as well as loan pools. The responsibility of the purchaser does not end with the initial due diligence analysis. Guidance should address completing routine monitoring, including obtaining timely financial information to evaluate the ongoing credit risk. If loans are purchased at a premium price, refer to the *Risk Management* procedure in the *Investments Examination Manual* topic for guidance on examining due diligence and risk management processes. Loans purchased at premium prices are subject to the same risks as investments purchased at premium prices.
- **Agreements: Does the institution ensure that loan and lease participation agreements and purchase and sale agreements adequately define the duties and responsibilities of the parties involved and include the minimum information required by regulations?** The institution should have guidance and controls to ensure agreements include the required information and are properly executed for each transaction. FCA Regulations [614.4325\(d\)](#) (loans) and [616.6100\(c\)](#) (leases) identify minimum requirements for agreements to purchase or sell an interest in both individual or portfolios of loans or leases. In addition, FCA Regulation [614.4330\(a\)](#) requires institutions to have participation agreements for all loan participation purchases and sales. This regulation states that participation agreements must, at a minimum, address nine specific items in addition to the items required in FCA Regulation [614.4325\(d\)](#). The institution should consider the legal and administrative risks associated with loan purchases and sales and ensure that agreements provide specific terms and conditions for loan administration and lender protection.
- **Borrower Stock and Borrower Rights: Does the institution ensure that borrower stock requirements and borrower rights protections are in place when a loan or other interest in a loan is sold?** The institution should have guidance and controls to ensure compliance with applicable borrower stock and borrower rights requirements for each transaction. FCA Regulation [614.4335](#) requires that borrowers meet the minimum stock purchase requirements at the originating institution unless loans are: (1) being sold into the secondary market, or (2) sold to another institution where the borrower may elect to hold stock at the purchasing institution. Further, FCA Regulation [617.7015](#) requires borrower rights protections unless the loan is being sold into the secondary market. If the loan and servicing rights are sold to a non-qualified lender, similar borrower protections must be included in the language of the loan contract or written consent must be obtained from the borrower to waive borrower rights. When a loan or an interest in a loan other than a participation interest is sold with servicing rights or the institution purchases a loan or a non-participation interest therein, refer to FCA Regulation [614.4337](#) for disclosure requirements. Refer to FCA’s [FAQs about Borrower Rights](#) (#7, #49, and #51) for additional information about borrower rights exemptions and waivers for loan sales.

- **Board and Management Oversight: Do the board and management provide adequate oversight of loan purchases and sales?** The board and management should periodically review loan purchase and sale policies and procedures for continued adequacy and relevancy of guidance and controls. Additionally, management should provide the board with reports on loan purchase and sale activities to ensure continued compliance with regulatory requirements and alignment with the board’s philosophy. The board should be involved in determining strategies and risk tolerances for loan purchases and sales. The institution should only enter into purchase and sale agreements when fully understanding the risks involved with the transactions and counterparties.
- **Training and Communications: Do training and other communication processes enable staff to understand and apply the loan purchases and sales regulatory requirements and related institution guidance?** Periodic training should ensure that staff are familiar with regulatory requirements and the institution’s guidance in these areas. Processes should ensure changes to policies, procedures, or other controls are timely communicated to staff.
- **Other Internal Controls:** Are other internal controls sufficient to ensure loan purchases and sales are handled in compliance with policies, procedures, and regulatory requirements? In addition to written guidance and training, the institution should consider other controls such as delegated lending authorities, management review and supervision, standardized forms, and checklists to ensure compliance with policies, procedures, and regulatory requirements. These controls are important to ensure loan data is accurately reported internally and to FCA. Additionally, the independent internal credit review function should provide adequate coverage of loan purchases and sales. Refer to the *Audit/Review* procedure for examining loan purchase and sales audits. Refer to the *Transaction Testing* procedure for evaluating compliance with loan purchase and sale requirements during FCA loan examinations to determine if internal controls are functioning effectively.

## Examination Procedures and Guidance

### Administration of Specific Lending Programs

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

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

#### Guidance:

A capital markets lending program refers to programs that exist to facilitate multi-lender transactions for large corporate and agribusiness customers. Capital markets consist of both the primary market (where new loans are originated and sold) and the secondary market (where existing loans are traded between investors). Both public, private, and middle market companies may seek capital markets financing to fund general operating expenses and working capital needs, capital expenditures, project financing, acquisitions, and other long-term initiatives. Loan structures can be complex. Multi-year facilities, senior secured and senior unsecured, extended draw periods, multiple tranches, and accordion features are common. Capital markets lending requires an institution (as a buyer or seller) to have an in-depth knowledge of financial markets and loan products. Additionally, significant industry expertise and experience underwriting, structuring, and closing loans are needed to originate and lead these transactions. Multi-lender financing arrangements allow borrowers to access a larger pool of capital at a lower cost than a single lender

could provide. These financing requests generally exceed an institution's hold limit or risk appetite and are accomplished through loan participations, syndications, loan assignments, and other arrangements. As discussed in the *Loan Purchases and Sales* procedure, System institutions have the authority to participate in loans with System and non-System lenders, but any type of loan purchase or sale must comply with FCA Regulation 614 Subpart H.

Capital markets lending programs can facilitate portfolio growth and diversification. Through loan purchases, an institution can spur loan growth, diversify the portfolio by industry and geographic region, and invest in large loans with reduced servicing and origination costs. Participation sales allow an institution to maintain compliance with internal and legal lending limits, reduce concentration risk, and manage capital. Partnering with non-System lenders can provide access to capital markets without presenting undue risk exposure to the System. Whether involved with System or non-System lenders, institutions should adequately evaluate counterparty risk as discussed in the *Counterparty Risk* procedure in the *Concentration Risk Management* Examination Manual topic. Institutions should have a high level of confidence in the lenders they choose to work with on multi-lender transactions. It is critical for institutions to appropriately administer and manage capital markets loans and maintain adequate portfolio management practices. This should include adequate guidance, standards, and internal controls to identify and manage the credit, operational, legal, and reputation risks associated with these transactions.

**Note: This procedure should be completed when an institution maintains a formal capital markets lending program or is highly active in capital markets lending.** These lending programs may go by other names such as corporate lending, agribusiness finance, loan syndication program, etc. **Completing the *Loan Purchases and Sales* procedure should be sufficient when evaluating an institution that primarily purchases participation interests and is not actively involved in complex capital markets lending.** This procedure overlaps with components from other loan portfolio management procedures but provides for a more in-depth evaluation of capital markets loan program administration.

Evaluative questions and items to consider when examining capital markets program administration and practices include:

- ***Policies and Procedures: Do policies and procedures provide adequate direction for administering capital markets loans?*** Capital markets lending guidance should be commensurate with the size and complexity of the institution's capital markets portfolio and risk-bearing capacity. As discussed in the *Credit Administration Guidance and Standards* procedure, the institution must have adequate guidance for administering all loans. However, the following specific considerations should be evaluated as part of capital markets loan administration guidance:
  - *Financial Information* – The institution should require annual audited financial statements for capital markets transactions. Reporting requirements may also include periodic financial reporting such as quarterly or monthly, which is typically company prepared. Guidance should outline any circumstances where less-than fully audited financial information would be sufficient. For example, there may be circumstances where a borrower has strong financial reporting processes, proven internal controls and testing, and the institution obtained a third-party collateral audit or other verification to ensure the integrity of the borrower's financial information.

- *Loan Structure and Conditions* – The institution should ensure that capital markets structures and repayment terms adequately protect the lender in the event of borrower performance problems. The institution should utilize meaningful financial covenants (e.g., minimum liquidity, leverage, and repayment coverage ratios) as well as periodic reporting requirements. Other loan covenants such as affirmative, negative, or restrictive covenants should also be used as appropriate. Compliance with loan covenants should be evaluated at least annually and more frequently per the credit agreement. In the event a borrower is in violation of a covenant or covenants, the institution should take other action to enforce the covenant, complete a credit action to waive the violation, or defer the covenant, as permissible per the credit agreement. Sufficient support should be evident for the action taken.
- *Covenant Lite* – Some institutions make covenant-lite loans in which meaningful financial covenants are absent or rely solely on incurrence covenants. Incurrence covenants are covenants that are only triggered by an event such as paying a dividend, making an acquisition, or issuing more debt. Incurrence covenants do not provide as much control as financial maintenance covenants that are routinely monitored and tested. The institution should identify whether a loan is covenant lite and document its rationale, support, and approval of these higher-risk transactions.
- *Unsecured* – Unsecured capital markets lending should be risk based, and the institution should have guidance that addresses risk rating requirements, including loss given default ratings that are consistent with System guidance.
- *Business Valuation* – Institutions often rely on enterprise value and other intangibles when evaluating the feasibility of a loan request and estimating the strength of a secondary source of repayment. They are also the basis for assigned loss given default ratings for capital markets accounts. Given the specialized knowledge needed for developing a credible enterprise valuation and its importance in underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of the origination function. There are several valuation approaches, including discounted cash flow, income multiple, and asset liquidation. Regardless of the methodology used, the assumptions underlying enterprise-value estimates should be clearly documented and well supported. If the primary source of repayment becomes inadequate, it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Support may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the borrower’s distressed circumstances and potential changes in business and market conditions.
- ***Loan Underwriting Direction: Does loan underwriting direction include appropriate standards for capital markets lending?*** As discussed in the *Loan Underwriting Direction* Examination Manual topic, the institution must establish measurable underwriting standards to support loan decisions. However, an institution with significant involvement in capital markets lending, especially those that serve as lead lenders, should adopt underwriting standards specific to its capital markets portfolios. The institution should tailor underwriting standards to ensure the metrics are appropriate to evaluate capital markets borrower’s financial performance. The institution involved in leveraged lending should understand the

risks and implications as discussed in the [Interagency Guidance on Leveraged Lending](#) published March 22, 2013. Leveraged lending refers to borrowers with elevated levels of debt and debt service requirements compared to cash flow. Guidance should address when leveraged lending may be acceptable and mitigating controls to manage the increased risk exposure. The institution should follow System guidance for determining how corporate credit ratings translate to probability of default assignments.

- **Monitoring Risk Identification: Are processes in place to adequately monitor capital markets accounts and update risk ratings?** Capital markets loans should be monitored frequently based on size and risk rating (probability of default and loss given default). At a minimum, an annual review should be completed with more frequent reviews considered when emerging risk factors could impact the risk rating. As discussed in the *Risk Ratings* procedure in the *Risk Identification* Examination Manual topic, institutions should have effective processes to coordinate with other institutions on risk ratings assigned to shared assets. This would include coordination as either the designated System lead or a System participant. An institution that serves as the System lead is responsible for establishing risk ratings and assigning a Shared Asset Number. The System lead is responsible for sharing its risk rating analysis and communicating any risk rating changes to other System participants. Participating institutions must still perform their own independent analysis since they are ultimately responsible for assigning their own risk ratings. While FCA expects participating institutions to report the risk in shared assets consistently, there may be instances where differences are warranted (e.g., the System lead's risk rating is inaccurate). These differences should be justified, documented, and communicated with the System lead. Timely and consistent risk identification for shared assets is important to ensure accurate loan portfolio quality is disclosed to shareholders, investors, and FCA.
- **Board and Management Oversight: Do the board and management provide adequate oversight of capital markets lending?** The board and management should consider their risk appetite and strategic goals when determining the level of involvement in capital markets lending. As discussed more in the *Loan Purchases and Sales* procedure, FCA Regulation [614.4325\(c\)](#) requires the institution to establish a board policy with specific provisions for identifying and reporting purchased and sold loan volume as well as limits on purchased volume and counterparty risk exposures. The institution should also monitor counterparty risk exposure from syndicate partners. Management should provide the board with routine reports on pertinent information related to capital markets lending to evaluate whether any changes are needed to the strategic direction, guidance, or controls over the program.
- **Training and Communications: Does the staff administering capital markets loans have sufficient experience and training in capital markets lending?** The institutions should ensure staff administering and approving capital markets transactions have an appropriate level of training and expertise. Training should ensure staff are familiar with loan purchase and sale regulatory requirements, the institution's capital markets lending guidance, and industries being financed. Processes should ensure regulatory, policy, procedure, or other control changes are communicated to staff.
- **Other Internal Controls: Are other internal controls sufficient to ensure capital markets loans comply with policies and procedures?** The board and management should implement effective internal control processes to ensure proper capital markets loan administration. Internal controls may vary depending on the size and complexity of the institution's capital markets portfolio. As discussed in the *Internal Controls* procedure, examples include

documented guidance, standardized forms, checklists, delegated lending authorities, loan committees, management supervision, and segregation of duties. Typically, capital markets loans go through committee review and approval due to transaction size and complexity. The institution should also ensure adequate coverage of capital markets lending as part of the internal credit review function. Refer to the *Audit/Review* procedure for examining capital markets lending program audits. Refer to the *Transaction Testing* procedure to evaluate capital markets administration during FCA loan examinations.

## **2. Scorecard Lending:**

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

### Guidance:

Scorecard lending refers to underwriting programs that rely on scoring models to evaluate credit risk. Credit scoring models use statistical methodology to quantify an applicant's probability of default based on limited predictive data. Typically, a credit scoring model will use an applicant's credit bureau information to predict future repayment performance and rank order risk. Other qualitative and quantitative factors may also be considered. For example, information obtained from financial statements and information about the size, age, and type of business are also common components. When used effectively, scorecard lending programs can promote consistency in the underwriting process and improve operating efficiency and profitability.

Because scorecard programs rely on credit scoring models, it is important the institution applies appropriate model risk management practices to protect the integrity of the scoring process. Scorecard lending programs with fully automated decisioning rely even more heavily on the accuracy and integrity of data input into the model. The institution should maintain strong internal controls to prevent and detect errors and misuse of scorecard loans, and ensure the model is functioning as intended. Scorecard lending program effectiveness depends on the policies and procedures established to guide and enforce proper use. The board and management should routinely monitor scorecard portfolio performance to ensure that credit scoring processes identify risk accurately and performance aligns with the institution's risk appetite and business goals.

Evaluative questions and items to consider when examining scorecard lending programs include:

- ***Policies and Procedures: Do policies and procedures provide adequate direction for administering scorecard loans?*** Board policy should outline the objectives and parameters for scorecard lending. Involvement in scorecard lending should be risk based and scorecard loan criteria should result in loans that are made within an institution's risk-bearing capacity. Guidance should address the following:
  - Establish authorities and responsibilities over credit scoring programs, including reporting and monitoring portfolio performance as well as reviewing and approving overrides.
  - Specify when a loan can be processed through a scorecard or automated lending function and when additional manual review may be required. Criteria should include limits on loan size and aggregate customer volume as well as a minimum or cut-off approval score. At a minimum, the cut-off approval score should align with an Acceptable classification (i.e., probability of default 9 or better). While an institution may allow loans to be approved below the minimum cut-off score, the



number and volume of loans approved as exceptions should be limited and reported.

- Include minimum financial and credit information to be gathered on scorecard loan applicants. In the case of co-applicants, the guidance should specify whose credit score will be used in the scorecard analysis (e.g., primary applicant, lowest credit score).
- Define the age of financial information acceptable for use, the level of verification required, and the frequency for obtaining updated financial information. For example, if a borrower is delinquent or shows other signs of increasing risk, obtaining an updated credit report can result in better loan servicing and risk identification.
- Set collateral valuation and inspection requirements, as applicable.
- **Models: Is the credit scoring model 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?** The model(s) 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.*
- **Board and Management Oversight: Do the board and management provide adequate oversight of the scorecard lending program?** The board and management should consider their risk appetite, strategic goals, and portfolio makeup when determining the appropriate level of scorecard lending. Management should monitor and provide the board with pertinent reports related to scorecard portfolio performance (e.g., growth, quality, overrides). Reporting frequency should be commensurate with the level of risk and complexity in the portfolio and ensure the board receives timely information. In addition to ensuring scorecard loans remain in compliance with any policy requirements, the board and management should also monitor scorecard portfolio quality and growth to determine if performance aligns with business goals and risk appetite. The board and management should also ensure the model accurately identifies risk and predicts default and loss rates to evaluate whether any changes are needed to the strategic direction, guidance, or controls over the program. Guidance may need to be updated based on changes in the lending environment, loss experience, or other material events. These actions could include increasing minimum cut-off scores, reducing individual loan size and aggregate portfolio limits, and requiring additional borrower financial information for loans perceived to have higher risk.
- **Training and Communications: Do training and other communication processes enable staff to understand and apply scorecard lending guidance?** The institution should ensure that staff administering scorecard programs receive appropriate training and guidance to consistently use the credit scoring model and apply relevant guidance. Processes should ensure policy, procedure, or other control changes are communicated to staff.

- ***Other Internal Controls: Are other internal controls sufficient to ensure scorecard lending practices comply with the institution's policies and procedures?*** The board and management should implement effective internal control processes to ensure proper administration of scorecard loans. In addition to written guidance, training, and controls over the scorecard model, the scorecard lending program should have adequate controls to prevent and detect misuse or fraud. For example, the institution should ensure appropriate segregation of duties for administering the scorecard program. If manual overrides are allowed for automated decisions, those overrides should be flagged and monitored. The institution should also ensure adequate coverage of scorecard programs as part of the internal credit review function. Refer to the *Audit/Review* procedure for examining scorecard lending program audits. Refer to the *Transaction Testing* procedure to evaluate scorecard loan administration during FCA loan examinations.