FCA's Use of Enforcement Actions

A97-03

Farm Credit Administration

Office of Inspector General
1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4030

May 27, 1998

The Honorable Marsha Pyle Martin
Chairman and Chief Executive Officer
Farm Credit Administration
McLean, Virginia

Dear Ms. Martin:

We have completed our evaluation of the Farm Credit Administration's (FCA or Agency) use of enforcement actions. The objectives of this audit were to (1) evaluate FCA's use of enforcement actions in obtaining corrective actions in Farm Credit System institutions; and, (2) document and evaluate FCA's current organizational structure and process as it pertains to achieving enforcement objectives.

The Agency's enforcement actions have, for the most part, been effective. Our review identified opportunities to enhance the timeliness and efficiency of enforcement actions by: eliminating the use of supervisory letters as enforcement documents; establishing due dates for completing key steps in enforcement actions; establishing formal criteria for terminating enforcement actions and returning the institution to a normal level of supervision; and reviewing reporting requirements imposed on institutions under enforcement actions for duplicative or nonessential aspects. The transfer of the enforcement function from the former Office of Policy Development and Risk Control to the Office of Examination addresses the need to streamline the Agency's organization of enforcement activities. Increased delegations of enforcement authority by the Board may further improve timeliness and efficiency of enforcement actions taken.

This audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General for audits of Federal organizations, programs, activities, and functions. Fieldwork was conducted from November 1997 to January 1998 at FCA headquarters in McLean, Virginia. An entrance conference was held on November 25, 1997. A draft of this report was provided to management on March 25, 1998 and, based on a report conference with management, revised and reissued on April 30, 1998. Their written response is included in this report.

Respectfully,

Eldon W. Stoehr
Inspector General

Table of Contents

Objectives, Scope and Methodology 1

Background 1

Findings, Conclusions and Recommendations 2

FCA's Enforcement Actions Have Generally Been Effective. However, Opportunities Exist to Enhance the Timeliness and Efficiency of Enforcement Actions 2

The Agency should eliminate the use of supervisory letters as enforcement documents 2

Criteria should be established for determining when termination of enforcement actions should occur and institutions returned to a normal level of supervision 2

The Agency should review its reporting requirements for institutions under enforcement actions and eliminate any that are duplicative or non-essential 3

The Organizational Structure and Practices of FCA's Enforcement Activities 3

The recent transfer of enforcement responsibilities between the former OPDRC and OE has improved the organizational structure and process related to the Agency's use of enforcement actions. 4

The Board may wish to delegate authority for some enforcement actions. 5

Enforcement activity has significantly declined. 5

Management's Response

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of this audit were to: (1) evaluate the Farm Credit Administration's (FCA or Agency) use of enforcement actions in obtaining corrective actions in Farm Credit System (System) institutions, and (2) document and evaluate FCA's current organizational structure and process as it pertains to achieving enforcement objectives.

We reviewed selected enforcement action activity taken by the Agency from January 1, 1990 to September 30, 1997. We reviewed the case files for those institutions with enforcement actions in place for more than five years and reviewed a sample of actions proposing conditions of mergers or reorganizations taken during each fiscal year. We also reviewed Agency policy and procedures guiding the use of enforcement actions.

We documented the Agency's organization and practices for enforcement activity and surveyed five other Federal financial regulatory agencies' characteristics and guidelines for enforcement actions. The survey was conducted through telephone interviews with individuals in those agencies who were either directly involved in or knowledgeable about their respective agency's enforcement action process. In addition, we interviewed Agency staff involved in the enforcement process.

BACKGROUND

The FCA is an independent Federal financial regulatory agency of the United States government with regulatory, examination, and supervisory responsibilities for the System banks, associations, and related institutions that are chartered under the Farm Credit Act of 1971, as amended (Act).

FCA derives its enforcement authority from the 1985 Amendments to Title V, Part C, of the Act, (12 U.S.C. Section 2261 et seq.) which grants the Agency certain enforcement powers for the purpose of effecting corrective action in System institutions. It is FCA's practice that institutions requiring "more than normal supervision" be considered for enforcement action. Generally, "more than normal supervision" is given to System institutions which: (1) are assigned a Farm Credit Administration Rating System composite rating of 3, 4, or 5; (2) exhibit individual characteristics that pose excessive risk to the institution regardless of its composite rating; and/or (3) may require punitive action to effect correction. This special supervision has included supervisory letters, supervisory conditions of merger or corporate restructuring, written agreements, cease and desist orders, and civil money penalties. The Agency also has the authority to remove officers; however, this authority has not yet been used.

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

FCA's Enforcement Actions Have Generally Been Effective. However, Opportunities Exist to Enhance the Timeliness and Efficiency of Enforcement Actions.

Recommendation No. 1: The Agency should eliminate the use of supervisory letters as enforcement documents.

The Agency should make a clear distinction between supervisory correspondence and enforcement documents. During the review period, supervisory letters were commonly considered enforcement documents even though they are, in fact, a warning or supervisory direction and not enforceable. Sixty-nine percent (233 out of 337) of all "enforcement actions" taken (as defined by Agency enforcement statistics) during the period reviewed were supervisory letters. Most supervisory letters we reviewed were essentially a restatement of actions requested in the report of examination. The process for deciding to send a supervisory letter primarily involved Office of Examination (OE) and the Office of Policy Development and Risk Control (OPDRC) without review or approval by the FCA Board.

Notwithstanding the absence of legal enforceability, there was a deliberate Regulatory Enforcement Committee (REC) strategy to use supervisory letters as warnings and to exert pressure on institutions to correct weaknesses identified in reports of examination. We think the use of supervisory letters as enforcement documents does not properly distinguish between the separate supervision and enforcement responsibilities of the Agency and may dilute the impact of the report of examination.

We believe the supervisory benefits that may have accrued from the previous use of supervisory letters can be obtained more efficiently within the examination process. When an examination identifies supervisory concerns, the examination report transmittal letter can communicate a warning, and the gravity of Agency concerns could be underscored by having higher ranking OE officials present such reports; i.e., the field office director or the Chief Examiner.

Recommendation No. 2: Criteria should be established for determining when termination of enforcement actions should occur and institutions returned to a normal level of supervision.

Some articles in enforcement documents, designed to improve a condition, lacked appropriate focus or specificity. In some instances, the goal to be achieved was imprecise or ambiguous. "Full compliance" with the articles in the enforcement document did not always eliminate the conditions which caused the enforcement action nor was the action always terminated when full compliance was documented.

Our discussions with staff in the Risk Control Division (RCD) disclosed an informal target that institutions under enforcement action should improve sufficiently to permit the enforcement

action to be lifted within three years. The majority of enforcement actions were, in fact, removed within the three-year period; however, there were several instances in which the Agency found insufficient improvement to support removal of the action within that time. Sometimes one enforcement document was lifted but was replaced with another document. We also found five individual enforcement documents, which were in effect for in excess of five years. In those cases, subsequent examinations identified new concerns which the institutions were required to resolve before the document was lifted, even though there was "full compliance" with the articles of the original enforcement document for a prolonged period of time. Documentation in the enforcement files evidenced frustration and confusion by System officials over this situation.

We believe the lessons learned through past enforcement experiences should equip Agency staff to now establish specific criteria to identify the conditions for lifting an enforcement document. Performance measures developed for FCA's enforcement activities should integrate the objectives and criteria for placing and lifting enforcement documents.

Recommendation No. 3: The Agency should review its reporting requirements for institutions under enforcement actions and eliminate any that are duplicative or non-essential.

Some enforcement actions imposed burdensome reporting requirements. The Agency's enforcement practices have steadily evolved over the past decade; nevertheless, we noted numerous instances in which enforcement documents required initial copies and continuing reporting to both the Director of the respective OE field office and the Director of the RCD. This practice is not only burdensome to institutions but also contributes to an inefficient use of Agency resources through the redundant processing and reviewing by two or more, separate FCA organizations. We did note instances in which reporting requirements were reduced, but only after institutions complained or requested relief--not because of Agency monitoring or assessment of information needs. As a general rule, internal FCA distribution should be an Agency responsibility.

The Organizational Structure and Practices of FCA's Enforcement Activities.

The enforcement practices reviewed during this audit were performed under the joint administration practices of OE and the OPDRC. The OE and the OPDRC/RCD were jointly responsible for regulatory oversight of institutions under enforcement action. OE had responsibility for examining and monitoring the performance and condition of all System institutions, while the RCD was responsible for oversight of institutions operating under enforcement documents.

Enforcement actions were initiated by findings of an OE examination or through monitoring activities. When these activities identified conditions in institutions calling for "more than normal supervision," OE would recommend an enforcement action, supported by a Supervisory Action and Monitoring (SAM) form which detailed the basis for the enforcement action and

recommended specific articles for inclusion in the document. The report of examination transmittal letter to the institution normally included a comment that the report had been forwarded to the OPDRC for consideration of enforcement action.

OPDRC staff would then perform an independent evaluation of the basis and appropriateness of OE's enforcement recommendation and draft an enforcement document, usually by tailoring model articles developed to correct similar deficiencies in other System institutions. The OPDRC draft action (with supporting documents) would then be forwarded to the Regulatory Enforcement Division (RED) of the Office of General Counsel (OGC) for legal review. The draft action (amended as appropriate) would then be forwarded to the responsible OE field office for any further input. The draft action was then submitted to the REC comprised of the Director of OE, Director of OPDRC (Chairman), and the Agency's General Counsel. The REC deliberations included non-voting participation from the Director of the RCD, Associate General Counsel of OGC's RED and the Official for Risk Management of the Farm Credit System Insurance Corporation. The REC would review the draft action, make revisions as appropriate, and then forward the recommended action to the Board. Upon Board approval, staff would be delegated appropriate authority to negotiate and execute the document with the System institution.

The recent transfer of enforcement responsibilities between the former OPDRC and OE has improved the organizational structure and process related to the Agency's use of enforcement actions.

Subsequent to the December 19, 1997 FCA Board action which transferred enforcement responsibility from OPDRC to OE, the Special Examination and Supervision Division within OE assumed the duties previously performed by the OPDRC/RCD. The OE Director now chairs the REC. In addition, OE field offices now prepare a new document called the Recommendation for Enforcement Action Memorandum that replaces the SAM and a portion of the evaluation previously drafted by the enforcement examiner. OE is currently developing procedures to reflect these organizational and procedural changes.

Our review of the Agency's former structure and process identified streamlining opportunities. These opportunities became more evident through our benchmarking of other regulators, which had also organized enforcement functions similar to the recent FCA Board action. The recent actions taken by the Agency have addressed several of the opportunities to eliminate redundant activities and make the process more efficient. Other regulators have also delegated some authority to take enforcement actions, primarily for actions of a remedial nature. However, some regulators have also delegated authority for imposition of civil money penalties and removal of officers. Currently, the FCA Board approves all enforcement actions.

The Board may wish to delegate authority for some enforcement actions.

The involvement of the Board in enforcement actions increases the time needed to place an institution under enforcement. The average time from the exit conference date of the examination until the placement of the action was over five months (160 days) for the sample of actions we reviewed, with a range of 90 days to 254 days. The average for the last ten actions showed an improvement as the average was lowered to 133 days with a range of 90 to 175 days. The importance of serving the document in a timely manner is self-evident in terms of the Agency mission to promote the safety and soundness of the System. Further, institutions have stated that the time afforded them to take corrective action is not sufficient when the next full examination follows closely behind the date of the enforcement action. The recent transfers within FCA should help to reduce the time lag between the date of the examination exit conference and the placement of the enforcement document. However, the delegation of additional authority would also help to expedite the process.

Enforcement activity has significantly declined.

The number of enforcement actions sharply declined during the period from December 31, 1989 to December 31, 1997, reflecting the tremendous improvement in the financial condition of the System. This decline is illustrated by the yearend statistics in the following.

December 31,	Number of Institutions	Total Assets Under Enforcement Actions
1989	72	$45 Billion
1990	88	$52 Billion
1991	77	$50 Billion
1992	65	$33 Billion
1993	49	$23 Billion
1994	26	$27 Billion
1995	08	$ 8 Billion
1996	06	$ 1 Billion
1997	05	$ 3 Billion

The composite CAMEL (Capital, Asset quality, Management, Earnings, and Liquidity) ratings for individual institutions for the same period also illustrate this marked improvement in the condition of System institutions. Only 8 of 208 institutions (3.8%) carried a composite CAMEL rating of "3" or lower at December 31, 1997, compared with 150 of 257 institutions (58.4%) at December 31, 1989.

Management's Response

A97-03

Memorandum

Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

FCA
FARM CREDIT ADMINISTRATION

May 15, 1998

To: Eldon Stoehr
Inspector General

From: Marsha Pyle Martin
Chief Executive Officer

Subject: Final Draft of Audit #97-03, FCA's Use of Enforcement Actions

Thank you for the opportunity to comment on the final draft report entitled "FCA's Use of Enforcement Actions" (report). I am pleased with your conclusion that the Farm Credit Administration's (FCA) enforcement actions have, for the most part, been effective. Notwithstanding this conclusion, improvements should be made and, as noted in the attached memorandum from Roland Smith, management agrees with the recommendations contained in the report.

I am not inclined to delegate authority for some enforcement actions now held by the FCA Board any further as discussed on page 4 of the report. Our process is designed to ensure the Board's understanding and support of each recommended enforcement action. There should be no reason the Board involvement would slow this process down in any way. I would expect that the level of preparation required for presentation of an enforcement action to the Board would be standard operating procedure.

Should you have questions or wish to discuss the response, please contact me or Roland.

Attachment

Copy to: James Ritter
Roland Smith
Tom McKenzie
Jean Noonan

Memorandum

Chief Examiner's Office
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

FCA
FARM CREDIT ADMINISTRATION

May 12, 1998

To: Marsha Pyle Martin
Chairman and Chief Executive Officer

From: Roland E. Smith, Chief Examiner
Office of Examination

Subject: Response to Office of Inspector General Audit #97-03
FCA's Use of Enforcement Actions

We received a copy of the Final Draft, dated April 30, 1998, of the above-mentioned report. We believe each of the recommendations of the Office of the Inspector General (OIG) has merit and, thus, were incorporated in the Office of Examination's (OE) operations and procedures for enforcement actions earlier this year. We are in the process of documenting these procedures to reflect these changes. The following response addresses the recommendations contained in the audit.

Recommendation 1: ***The Agency should eliminate the use of supervisory letters as enforcement documents.***

We agree with the recommendation and had changed operating procedures when the enforcement function was transferred to OE in January 1998.

The use of supervisory letters, prior to the transfer of the enforcement function to OE's Special Examination and Supervision Division (SESD), was used by the Enforcement Division as an indication to an institution's board of directors that conditions existed in the institution serious enough to require more than normal monitoring and/or supervision. The use of these letters was a decision of the Chief of the Enforcement Division as recommended by staff. With the transfer of the function to SESD, we believe the benefits that were gained using supervisory letters can be obtained more efficiently within the examination and oversight process carried out by OE field offices. The audit states that the Regulatory Enforcement Committee (REC) used supervisory letters in the past as warnings and to exert pressure on institutions to correct

weaknesses identified in Reports of Examination. Normally, the use of supervisory letters did not include a decision by the REC.

OE Approach

Since the enforcement function has been placed in OE, the use of supervisory letters as described in the audit has been eliminated. The letter to a System institution board chairman included in the Agency's Report of Examination is the vehicle to inform the institution board of matters serious enough to require corrective action and more than normal monitoring and supervision. The responsibility for monitoring an institution's progress will reside with the applicable field office under the supervision of the OE Field Office Director. We believe this will result in a more efficient and effective process, streamline reporting and communications, and improve the timelines for obtaining corrective actions from institutions.

Recommendation 2: ***Criteria should be established for determining when termination of enforcement actions should occur and institutions returned to a normal level of supervision.***

While we agree with the overall intent of the recommendation, it is difficult to establish specific criteria for termination of enforcement actions. Some articles included in an enforcement document can be very specific, and some need to be somewhat less specific. To correct an unsafe and unsound practice, a very specific article can generally be utilized. However, to correct an unsafe and unsound condition, the wording of an article and timeframe required to effect corrective action may often need to be much less specific, and time needed to correct the condition can vary greatly and depend on the commitment of management and board. Wording of enforcement actions placed on System institutions is such that either party can make amendments and/or modifications to the requirements of individual articles for cause. In fact, much of the presentation time of an enforcement document to a board of directors is spent negotiating the wording of articles. This is necessary so that what is required of the institution is clear to both parties. Each party must be satisfied that remedial change can and will take place.

The Agency's Financial Institution Rating System (FIRS) sets supervisory levels of concern for institutions. With composite ratings of 3, 4, or 5, the level of monitoring and supervision is increased. The CAMELS factors, except "M," are generally objective in nature. The management factor is much more subjective and can affect ratings for the other factors. Nonetheless, the component ratings for assets, capital, earnings, liquidity, and sensitivity to market risk include objective criteria that quantitatively measures the institutions' position relative to specific performance data. This criteria, commonly referred to as the FIRS benchmarks, defines the ranges of operating performance for critical elements of these component factors that will be used to help determine when performance achieves an acceptable level. Accordingly, this and the management component benchmarks will be used to help determine when results have been sufficient to consider removing the enforcement action.

When staff presents an enforcement document, institution boards often ask when the document will be lifted. The response is that as soon as the condition of the institution improves to a point, no unsafe or unsound condition exists, violations (if any) of law or regulations have been corrected, and the board and management have demonstrated they can handle identified weaknesses in the normal course of business without the need of a remedial action, the action

will be recommended for termination. We hope that the end result of placing an enforcement action will be the correction of unsafe and or unsound conditions or practices in a reasonable time. However, many variables come into play when looking into the future condition of a bank or association, such as the economy (local, regional, national, and global), weather, Government programs, administration of credit, availability of new business, loan growth rate, and the capacity of the institution to recover financially. Management can control only some of these variables.

The Agency has established a 3-year period as a performance measure (standard) for evaluating our performance in dealing with enforcement actions. Presently, the 3-year performance measure is reasonable to assume. With all controllable factors being adequately addressed and no new unsafe or unsound conditions becoming evident, a System institution can assume that an enforcement document should be lifted within 3 years. Some documents can be lifted sooner; some documents will remain longer. We believe the FIRS benchmarks provide sufficient criteria that defines when institutions have reached a level of condition and performance that would prompt consideration to terminate an enforcement action. Accordingly, OE's operating procedures will incorporate this criterion to better define when institutions should return to a normal level of supervision.

Recommendation 3: ***The Agency should review its reporting requirements for institutions under enforcement actions and eliminate any that are duplicative or non-essential.***

We agree that, as a general rule, internal FCA distribution should be an Agency responsibility. OE's operating procedures will incorporate this concept.

When the Agency first obtained enforcement powers, institutions under action were required to report actions completed to comply with the articles of the enforcement documents to the Enforcement Division and the OE field office responsible for the examination of the institution. This reporting was deemed necessary due to the financial and credit condition of institutions in the System and the lack of internal controls that existed in many System institutions. As System institution boards of directors and management improved their oversight of operations, credit and economic conditions improved, and as the Agency's process of examination has evolved, the majority of reporting has been to a single Agency contact, most often the OE field office.

OE Approach

Now that the enforcement function resides in OE, even though purposefully kept separate and apart from the examination function, reporting by an institution under enforcement action to the field office is more appropriate. This is because the responsibility to measure the compliance to requirements of an enforcement action resides at the field office level. Reporting requirements, however, will continue to be assessed on a case-by-case basis. If the condition of a System institution under enforcement action is such that monitoring by SESD is necessary, information that has been submitted to the field office will be forwarded to the SESD enforcement examiner in McLean. Additionally, if an institution fails to respond appropriately to the field office, consideration will be given to transferring oversight of the enforcement action to the enforcement examiner in SESD.

AUDIT USER RESPONSE QUESTIONNAIRE

Audit Report Title: FCA's Use of Enforcement Actions

Number: A97-03

Respondent's Name:

Telephone:

Respondent's Office:

Today's Date:

	Strongly Agree				Strongly Disagree
Quality of the Audit Work and Report	Circle the number that best describes your response to the question.				
1. The audit report clearly indicates what areas were reviewed.	5	4	3	2	1
2. The audit report was clear, logical and understandable.	5	4	3	2	1
3. The audit recommendations, if any, were appropriate to the conditions and are achievable.	5	4	3	2	1
4. The OIG staff conducting this audit were professional, knowledgeable and objective.	5	4	3	2	1
Relevance to Your Work					
1. The audit report was timely for your purposes.	5	4	3	2	1
2. The areas addressed by the audit were of concern to your office.	5	4	3	2	1
3. Your comments, if any, were fairly stated and adequately addressed.	5	4	3	2	1

Please add any explanatory comments here, particularly for those rated 1 or 2: (Use an additional sheet if necessary.)

Please return this form to:

FCA Office of Inspector General
1501 Farm Credit Drive
McLean, VA 22102

If you would like to discuss your responses with the OIG, check the box and be sure to include your telephone number at the top of this form or call us on 703/883-4030. ☐