**Memorandum**

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

**Informational Memorandum**

December 16, 2009

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

From: Thomas G. McKenzie, Director and Chief Examiner
Office of Examination

Subject: National Oversight Plan for Fiscal Year 2010

Each year the Office of Examination develops a National Oversight Plan to detail strategies for addressing critical risks or other areas of focus in the Farm Credit System (System). The National Oversight Plan builds upon Farm Credit Administration (FCA) Chairman Strom's letter to you entitled *Confronting the Increased Risk Environment* (July 2, 2009). In his letter, Chairman Strom highlighted changing risk conditions and challenged boards of directors to take action. This Informational Memorandum provides insight into how FCA's examination program will evaluate these risks and provides questions you should address with your management as you develop your business plans and evaluate your control systems.

The Office of Examination's National Oversight Plan is a central component of our examination and oversight of System institutions. In this plan, we outline and prioritize key risk topics that FCA examiners will focus on in your institution and System-wide. The risk topics include:

1. Loan Portfolio Management
2. Large, Complex, and Shared Assets
3. Collateral Risk Management
4. Compensation Programs and Corporate Governance
5. Borrower Rights and Compliance
6. Liquidity Risk and Balance Sheet Management
7. Counterparty Risk

Please use the information in this memorandum to understand our priorities and items we believe are critically important to the safety and soundness of System institutions. This memorandum includes an attachment with several important questions, which examiners will be addressing with you or your management team. These same questions are also appropriate for the board of directors to address with management and provide a framework for a self evaluation of your institution. Please take the necessary time to review these issues with your

board of directors and management team and ensure your institution is ready to address increased risk facing the System.

The System's risk profile has changed markedly in the last several months. These conditions are evident in FCA's Financial Institution Rating System (FIRS) Ratings and increased supervisory activities. As of September 30, 2009, 15 System institutions had a composite rating of "3" or "4." This is a marked change from September 30, 2008 when five institutions had a composite rating of "3" or "4" — a three-fold increase. FCA and the Office of Examination are addressing these conditions and supervisory actions have increased in response. Twelve institutions are presently operating under higher than normal supervisory conditions.

System conditions have deteriorated and, with increased risks continuing to emerge in the agricultural sector, I expect further deterioration. I ask each System board director to consider this memorandum seriously, reflect on your fiduciary responsibilities, the mission of the System, and take decisive actions to ensure your institution is well-prepared to manage through these challenging times. Specifically, you should ensure that your institution's business plans, capital plans, and internal audit plans reflect a realistic view of current risk conditions and expectations of further deterioration. Importantly, you should ensure your institution has the necessary human resources, including the board of directors and executive management team, to address this risk. It is important that institutions act timely and prudently to manage through these current and difficult conditions to ensure dependable and constructive credit for farmers and rural America into the future.

Please distribute copies of this memorandum to your fellow board members and discuss its contents with the chairman of your Audit Committee, other appropriate committees of the board of directors, and your executive management team. You should also provide copies to the managers of the internal audit and credit review programs. If you have any questions about this memorandum, please contact your designated examiner-in-charge or Roger Paulsen, Director, Risk Supervision Division, at (703) 883-4265 (paulsenr@fca.gov), or me at (703) 883-4277 (mckenziet@fca.gov).

Attachment

Copy to:

Chief Executive Officer, All Farm Credit System Institutions
Chief Executive Officer, Farm Credit Council
Chief Executive Officer, Farm Credit Council Services

**Attachment**

This attachment outlines the Office of Examination's *National Oversight Plan* Risk Topics. It summarizes several important questions FCA examiners will be addressing with the board of directors or management. These same questions are appropriate for the board of directors and management to use as a self assessment.

## Loan Portfolio Management

Loan portfolio management encompasses all systems and processes used by the board of directors and management to adequately plan, direct, control, and monitor the institution's lending operations. The principle components of an effective loan portfolio management system include strategic portfolio planning, lending policies and procedures, loan underwriting standards and practices, a reliable risk identification program, concentration and portfolio limits/parameters, and an internal credit and collateral review program.

1. How do the business, capital, and portfolio/credit plans communicate the board of director's portfolio expectations and risk appetite? Are they consistent with existing and prospective risk conditions, the institution's risk-bearing and income generating capacity, internal control systems, and risk management capabilities?

2. How has the board of directors adjusted loan underwriting standards/practices and portfolio concentration limits/parameters (e.g., single borrower/large loans, industry, affiliated concentrations, out of territory volume, loan participations, land in transition, adverse assets, criticized assets, etc.) to address changing risk conditions and the institution's risk funds? How is the institution identifying, analyzing, and reporting loan underwriting exceptions?

3. How has the board of directors ensured that portfolio risk is identified in an accurate and timely manner and with sufficient granularity? How are risk identification systems used to effectively facilitate risk-based loan pricing, analyze the adequacy of the allowance for loan losses, and assess capital needs/adequacy?

4. How resilient is the loan portfolio in response to severe or sustained stress? Does the institution have a robust stress testing program in place which measures the effects of severe, yet plausible, credit stress on both portfolio quality and the institution's financial condition and performance? How are stress test results considered in the business, capital, and portfolio plans and in the institution's underwriting practices?

5. How has the institution's allowance for loan losses been adjusted to reflect the changed risk and portfolio conditions? Has the board of directors and management reviewed the revised FCA Examination Manual Section and Informational Memorandum on the allowance for loan losses distributed June 30, 2009? Does the institution have sufficient allowance for loan losses to absorb the increased credit and collateral risks? How has the institution utilized industry specific or event reserves within its general allowance to recognize increasing portfolio risk conditions?

## Large, Complex, and Shared Assets

Large, complex, and shared assets are a significant source of credit risk that can affect the safety and soundness of individual institutions and the System. The System's exposure to large assets has increased significantly in recent years, resulting in a significant increase in systemic risk. OE is increasingly concerned with the risk of these loans given their relative size and distribution across the System, and the resultant impact on System performance.

1. How has the board of directors evaluated portfolio risks (and concentrations) associated with large, complex, and shared assets?

2. How has the board of directors' enhanced processes, risk management systems, and controls to address the increased risk associated with large, more complex, and increasingly shared assets? How does your institution monitor individual or aggregate portfolio risks? How does your institution identify shared assets in your data systems and support System-wide data to manage System exposure to single loan counterparties?

3. How are these large, complex, and shared assets affecting portfolio risks and how has the board of directors responded to those risks in business plans, capital plans, portfolio plans (including internal lending/hold limits), allowance levels, and earnings objectives to reflect this changed risk profile?

4. How has the board of directors established audit and review plans to address the risks associated with large, complex, and shared assets, and the distressed industry conditions that are adversely affecting the quality of many of these assets?

## Collateral Risk Management

Collateral risk is intensifying as loan repayment sources erode or become erratic. Collateral risk has markedly increased in stressed portfolio segments or industries — especially land in transition, biofuel/ethanol, livestock (dairy, swine, and poultry), housing industry-related accounts (timber, nursery, and greenhouses), and recreational properties. Regional collateral risks are especially heightened in the southeast and southern regions of the country. While these regions are the center of the most immediate collateral risks, similar risk is spreading across the United States as recessionary conditions persist and major industries restructure.

1. Has your institution conducted any collateral risk studies? What is the institution's existing level of collateral risk, and how is it routinely monitored and assessed? Which portfolio segments are causing the most significant risk in the current environment?

2. How are recent sales reflective of portfolio conditions and collateral risk? If sales do not exist, what assumptions are used to drive values?

3. How has the board of directors adjusted its operations to manage this increased collateral risk?

4. How has increased collateral risk been factored into other areas of the loan portfolio management system (see above), including underwriting standards and portfolio stress testing?

## Compensation Programs and Corporate Governance

Compensation programs and corporate governance are growing regulatory concerns. These areas are core to a sound risk management culture and risk management practices. The changing business climate requires increased scrutiny of the quality of board operations and directorate—especially in an increasingly risky lending environment. In many institutions, FCA FIRS ratings highlight the need for improved board of directors' oversight and a greater focus on compensation programs.

1. How do the institution's compensation programs incent employees to promote the long-term goals of the institution? How are these compensation programs aligned with the System's mission, core values, and cooperative principles? How do compensation programs consider and focus on risk identification, risk management, and overall institution performance and prevent excessive compensation based on asset growth?

2. How is the institution enhancing the board of directors' composition and skills given increasing risk conditions? How frequent is the board of directors receiving specialized training? Does the board of directors have the requisite skills to manage the institution's increased risk profile or complexity of operations?

## Borrower Rights and Compliance

The current risk environment causes potential increases in adverse actions that affect borrower rights and consumer regulations compliance. As such, the board of directors should ensure borrower rights notices, as well as related policies and procedures, remain consistent with laws and regulations and the credit review committee is familiar and complies with regulatory requirements. While regulatory compliance is the law, FCA also expects the System to comply with borrower rights requirements because it is a good business practice and affects reputation risk of the System at large.

1. How has the board of directors ensured borrower rights are used effectively to promote the System's public policy mandate as a government sponsored entity serving agriculture and rural America?

2. How has the board of directors ensured the credit review committee is equipped to perform functions required by FCA Borrower Rights regulations?

3. How has the board of directors ensured policies, procedures and operating practices are consistent with regulatory requirements?

4. To what extent has the internal audit and review function evaluated compliance with borrower rights and consumer regulations?

## Liquidity Risk and Balance Sheet Management

Liquidity risk has increased significantly since mid-2008. The financial market turmoil in 2008/09 materially affected the System's historically stable and readily available funding mechanisms. These conditions also impacted the quality and ready liquidity of the System's marketable investments.

1. How has the board of directors managed risk in investments and adjusted the composition of investments to provide a reliable source of liquidity?

2. What strategies have been established to ensure the institution maintains ready access to funding given liquidity risks in today's environment? What secondary sources of liquidity does your institution have? What are they and how long will they last?

3. How has the institution managed off-balance sheet risks (e.g., loans, securitizations, derivatives, and counterparties)?

4. How has the board of directors adjusted its capital, earnings, pricing, patronage strategies, and other strategic business objectives consistent with portfolio growth and changes in portfolio risk?

5. What actions has the board of directors taken to address declining capital ratios or increasing credit risk relative to capital? Has the board of directors adjusted cash patronage payout ratios, slowed revolvement of allocated surplus, increased net interest margins, reduced operating expense rates, or issued new equity?

**Counterparty Risk**

Counterparty risk has significantly increased as System institutions conducted business with each other and non-System entities. Many institutions are dependent upon others to originate or service loans or perform material business functions (e.g., accounting and information technology). In some cases, institutions have become heavily reliant upon third parties to identify or manage credit risks. This increased level of counterparty risk for many System institutions results from participation and syndication activities, loan guarantors, derivative and investment transactions, and service providers, including technology and data systems.

1. Who are the institution's material counterparties? Which counterparties cause a significant risk exposure to the institution, or the System as a whole?

2. How has the board of directors evaluated the counterparty's financial condition and ability to perform? How is performance evaluated?

3. How has the board of directors limited or managed counterparty risk exposures? As appropriate, have counterparty risk limits been established for each counterparty (similar to a lending limit)?

4. How are your institution's counterparty exposures communicated to your funding bank for assessment of Systemwide counterparty exposures?