**Farm Credit Administration**

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

**Informational Memorandum**

March 4, 2010

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

Chief Executive Officer
All Farm Credit System Institutions

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

Thomas G. McKenzie

Subject: FCA's Stress Testing Expectations for All FCS Institutions

For many financial institutions, the past year was characterized by declining credit quality and increased loan losses. The challenges experienced in 2009 should have motivated all lenders to assess the adequacy of their loan portfolio management (LPM) practices. As noted in our recent Informational Memorandum (December 16, 2009) entitled *National Oversight Plan for Fiscal Year 2010*, evaluating LPM at Farm Credit System (System) institutions is a key priority for the Office of Examination (OE). LPM encompasses a wide range of systems and processes working in concert to plan, direct, monitor, and control an institution's lending operations.

Within the context of LPM and balance sheet management, stress testing represents a vital component in an institution's risk management process. An important goal of stress testing is to enhance both management's and the board's understanding of the risk embodied in the institution's portfolio under a range of operating environments. When done effectively, stress testing provides the board and management valuable information for use in key decisions such as setting capital goals, formulating underwriting standards, pricing loans, and establishing concentration parameters. Stress testing enables an institution to identify vulnerabilities by exposing it to plausible stress scenarios. Stressors may include items such as sharp changes in commodity prices or input costs, lower collateral values, or other adverse economic developments. Stress testing is a means for obtaining a better understanding of an institution's risk profile.

It is imperative that we learn from the experience gained by many financial institutions during this recent economic turmoil. According to the Basel Committee on Banking Supervision, bank stress testing was generally not adequate and should have included more severe stress scenarios.[1] The Basel Committee report also emphasized the critical importance of board and senior management involvement in the stress testing process.

[1] Basel Committee on Banking Supervision, "Principles for sound stress testing practices and supervision," Bank for International Settlements, May 2009.

> Board and senior management involvement is critical in ensuring the appropriate use of stress testing in banks' risk governance and capital planning. This includes setting stress testing objectives, defining scenarios, discussing the results of stress tests, assessing potential actions and decision making. At banks that were highly exposed to the financial crisis and fared comparatively well, senior management as a whole took an active interest in the development and operation of stress testing, with the results of stress tests serving as an input into strategic decision making which benefited the bank. Stress testing practices at most banks, however, did not foster internal debate nor challenge prior assumptions such as the cost, risk and speed with which new capital could be raised or that positions could be hedged or sold.

Stress testing is appropriate for all institutions regardless of size. Indeed, commercial banking supervisors have made a point of emphasizing that community banks ought to be stress testing their institutions.[2] Of course, the degree of sophistication of the models and analytics employed should be commensurate with the complexity and sophistication of each institution. Nevertheless, stress testing is expected to be a key component of an institution's risk management efforts. Every institution's stress testing process should be well thought out, internally consistent, defensible, and include both individual loan and portfolio stress testing. Furthermore, stress testing at different points of time throughout the year is beneficial as management can periodically assess the effectiveness of responses to previously identified vulnerabilities.

The Agency has made it clear in past communications that stress testing is expected as a sound portfolio management practice.[3] In our National Oversight Plan for 2010, we continue to emphasize the importance of stress testing. In upcoming examination activities, examiners will evaluate the adequacy of your institution's stress testing practices and review stress testing results. In past examination efforts, we have observed a rather wide range of stress testing capabilities among System institutions. As such, the board and management for each System institution should ensure the depth and breadth of their stress testing practices are sufficient.

FCA expects the board and management of every institution to be fully engaged in the stress testing process. The board sets the direction, while senior management implements the stress testing program. Attachment 1 further articulates FCA's stress testing expectations. Each institution is expected to have a stress testing program consistent with these expectations and stress testing should be incorporated into ongoing management and planning processes.

Please distribute copies of this memorandum to your board and discuss its contents with the Chairman of the appropriate board committee(s) (e.g., credit, risk, or audit) and your executive management team. You should also provide copies to the managers of the internal audit and credit review programs.

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[2] Ben S. Bernanke, "Community Banking and Community Bank Supervision," Speech delivered at the Independent Community Bankers of America National Convention and Techworld, Las Vegas, NV, March 8, 2006. Governor Daniel K. Tarullo, "Large Banks and Small Banks in an Era of Systemic Risk Regulation," Speech delivered at the North Carolina Bankers Association Annual Convention, Chapel Hill, NC, June 15, 2009. Interagency Guidance (OCC, Board of Governors of the Federal Reserve System, FDIC), "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," December 12, 2006.

[3] See Informational Memoranda dated November 14, 2008, National Oversight and Examination Program for Fiscal Year 2009 and July 2, 2009, Confronting the Increased Risk Environment.

Additional information and answers to frequently asked questions (FAQ) can be found on the FCA Web site. Because we plan to update these FAQs over time as we receive feedback from examiners and institutions, I encourage you to revisit them on the FCA website periodically. If you have any questions about this memorandum, please contact either your designated examiner-in-charge, Gordon Hanson, Credit Risk Program Manager, (877) 322-2566, ext. 5011, (hansong@fca.gov), or Stephen Gabriel, Senior Financial Analyst, (703) 883-4287, (gabriels@fca.gov).

Attachment

**Attachment 1**

**FCA's Stress Testing Expectations for Farm Credit System Institutions**

FCS Institutions' boards establish written policies and senior management implement procedures governing the stress testing program. Policies and procedures should address the frequency of stress testing, its role in the business planning process, and how the stress testing program is integrated into the overall risk management process. Policies should also specify a clear and central role for the board and senior management.

All institutions are expected to evaluate meaningful stress scenarios. The stress scenarios are expected to be well-documented and include a description of the underlying macroeconomic environment. Stress scenarios should address assumptions related to a range of factors. The factors analyzed by each institution should be those that are most meaningful and will vary depending on the composition and characteristics of the portfolio. Variables that should be analyzed include risk factors such as:

1. Commodity prices
2. Input costs
3. Production expectations
4. Farmland and other collateral values, particularly assumptions related to specialized collateral
5. Interest rates and spreads (consider both external and internal cost of funds)
6. Off-farm income
7. Government programs
8. Counterparty concentrations
9. Unfunded commitment exposure

Banks' stress testing should focus on each of the balance sheet's sources of risk, including the investment portfolio. Banks' loan portfolios include direct loans, participations purchased from associations and others, and retail loans. The stress tests of various components of the balance sheet, including the portfolio segments mentioned in the previous sentence, may require different approaches and/or methodologies. However, stress tests of each balance sheet component should be clearly linked to well-defined scenarios for the risk factors outlined above.

Various types of stress testing and sensitivity analyses may be conducted throughout the year. These analyses may be focused on very specific aspects of the institution's operations. However, at least once a year a comprehensive stress test of the institution should be performed. This comprehensive stress test should normally be incorporated into the annual business planning process. The comprehensive stress analysis is expected to show the impact of the stress scenarios over a three year horizon on:

1. Credit quality (including risk ratings, nonperforming and nonaccrual loans)
2. Provision for loan losses and allowance for loan losses
3. Capital and capital ratios
4. Earnings and earnings ratios
5. Liquidity and liquidity measures (including effects on GFAs and bank CIPA scores)

At least one scenario must constitute a substantial stress to the portfolio, one that is greater than expected (yet plausible) and involves more than a single industry/credit concentration being stressed.

There should be a discussion of whether, based on stress testing results, the board and management believe changes should be made to current lending activities (such as loan pricing, risk tolerance levels, loan underwriting practices and standards, borrower hold positions, etc.) and financial management practices (such as capitalization strategies and objectives, patronage, growth objectives, earnings, operating structure and efficiencies, etc.). Contingency plans should also be discussed. A summary of these discussions and the conclusions reached, along with actions to be taken, should be incorporated into the stress testing documentation.

The degree of sophistication of the models and analytics employed is expected to be commensurate with the complexity and sophistication of the institution. Nevertheless, every institution's stress testing process should be well thought out, well-documented, internally consistent and defensible. Indeed, every institution's stress testing process should be a vital and active component of the planning and decision-making process.

Although FCA is not dictating the specific stress testing methodology to be employed, the board and senior management should ensure that the stress testing process is meaningful and actionable. Accurate data and sound analytics are vital to portfolio management and stress testing. Institutions should consider the adequacy of loan portfolio data, including borrower financial data, and evaluate how it can be improved to support needed portfolio risk management analytical applications such as stress testing. Some institutions may find it beneficial to employ an agent or outside firm to help construct their stress scenarios and models.

The comprehensive stress testing analysis associated with the institution's business planning should go beyond assessing changes in portfolio quality that result from a stress scenario. Institutions should ensure stress testing processes include linkage to and integration with financial systems to facilitate projecting the effect of balance sheet stresses beyond asset quality and on to the institution's financial condition and performance.

A report to the board, or appropriate committees of the board, is expected to be prepared indicating the stress test's results. This should include identifying any specific actions that should be taken or pursued.

You may expect OE's exam program to evaluate the stress testing process and the board's evaluation of the results. The board and senior management should expect dialogue with examiners on the process and results. Some institutions will need time to develop a credible stress testing program. Nevertheless, all institutions are expected to have an operational stress testing program by yearend 2010. Stress test results are expected to be incorporated into the institution's 2011 business plans and subsequent business plans going forward. However, conducting periodic comprehensive stress tests throughout the year is advisable and during adverse economic periods, such as we are experiencing currently, stress analysis should be conducted no less than semi-annually.