



Informational Memorandum

March 3, 2009

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

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

A handwritten signature in black ink that reads 'Thomas G. McKenzie'. The signature is written in a cursive style with a long, sweeping underline.

Subject: Financial Institution Rating System

This Informational Memorandum communicates changes we have made to the Farm Credit Administration's (FCA) Financial Institution Rating System (FIRS). The FIRS is the rating system used by FCA examiners for evaluating and categorizing the safety and soundness of Farm Credit System (System) institutions on an ongoing, uniform, and comprehensive basis. It is modeled after the Uniform Financial Institution Rating System used by the other Federal financial institution regulators.

In its current form, the FIRS has served FCA effectively since 1998; however, consistent with FCA's desire to maintain a strong examination and supervisory program, we have revised the factors and related examination guidance used in the FIRS to better reflect the conditions and environment in which System institutions currently operate. Since the adoption of the FIRS, the size and complexity of System institutions has increased significantly, and the operating environment has become much more volatile. These conditions have generally resulted in increased risk that, if not effectively managed, can threaten the safety and soundness of System institutions. As such, the FIRS guidelines have been revised to place a greater emphasis on risk management and other factors that affect the safety and soundness of System institutions and compliance with laws and regulations. Some of the key changes made to the FIRS to accomplish this include:

- added "risk management" as a key factor to be considered and evaluated as part of the rating process;
- added more guidance to evaluate corporate governance, internal controls, and operations management;
- added "mission compliance" as a key factor considered in the evaluation of management;
- raised the return on assets benchmark used for evaluating association earnings;
- added "asset growth" and a large loan concentration measure as factors considered in the evaluation of assets; and
- added an efficiency ratio which measures operating expenses in relation to revenue.

In addition, because management is a key factor in determining the level of supervision established by FCA, the revised FIRS also includes additional guidance intended to more clearly differentiate between a 1 and 2 rating in management and directs examiners to give special consideration to management when assigning the institution's composite FIRS rating. In that regard, a 1 management rating under the revised FIRS will generally be reserved for those institutions with proactive risk management practices and strong internal controls. FIRS ratings for some institutions may be changed as a result of this increased emphasis.

The FIRS was also revised to broaden the number of factors considered in the rating process and to update the quantitative benchmarks used to evaluate the capital, assets, earnings, and liquidity of associations. While the changes to the "association benchmarks" were limited, several important revisions were made to the benchmarks used to evaluate assets and earnings.

Consistent with our ongoing oversight and examination program, FIRS ratings will be reviewed and updated as needed to reflect any material changes in the management, conditions, or risk profile of your institution. As we have done in the past, this review will be completed at least quarterly. We will formally communicate our FIRS ratings to you annually as of December 31 and whenever a rating is changed.

The changes discussed above have been incorporated into sections 135 and 199, Supplement 4, of the FCA Examination Manual. Section 135 provides a general description and overview of the FIRS process, whereas Section 199, Supplement 4 provides the ratings definitions and a detailed listing of the factors and criteria used by examiners in assigning ratings. These Examination Manual sections are available on FCA's Web site at:

Examination Manual Section 135 —

<http://www.fca.gov/examman.nsf/23487a899566697a85256bea004842b2/d4a45ff86dc5d8f6852561cd004cd5bf?OpenDocument>

and

FIRS Guide, Section 199, Supplement 4 —

<http://www.fca.gov/examman.nsf/23487a899566697a85256bea004842b2/4e71769353e126a785256716005904d9?OpenDocument>

I encourage you to review these documents carefully and discuss them with your board. They outline the process and criteria we will use beginning December 31, 2008, to assign FIRS ratings and establish our supervisory approach for your institution. The changes we have made are designed to improve transparency of FCA's ratings. As such, our letter documenting the FIRS ratings will include more information supporting the basis for your rating. Please use this opportunity to strengthen the dialog between the board of directors and FCA. This communication will help us to have a consistent understanding of the condition and performance of your institution.

If you have any questions or comments regarding these changes, please contact your designated examiner-in-charge or David Stephens, Director, Examination Policy Division, at (703) 883-4160, or by e-mail at (stephensd@fca.gov); and/or me at (703) 883-4277, or by e-mail at (mckenzie@fca.gov).