Farm Credit Administration

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

Informational Memorandum

November 14, 2008

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

Subject: National Oversight and Examination Program for FY 2009

Consistent with Farm Credit Administration (FCA or Agency) Board Chairman Strom's recent communications, the Office of Examination (OE) is committed to providing effective leadership and oversight of emerging risks. This Informational Memorandum provides a summary OE's 2009 National Oversight and Examination Program, which focuses resources on the most significant risks to the Farm Credit System (FCS or System). Please discuss the content of this memorandum with your institution's board and management team and implement actions now to address the significantly changing lending environment.

Our National Oversight and Examination Program (NOEP) is intended to be ongoing, dynamic, and carried out using FCA's risk-based philosophy. As such, several activities identified in our FY 2008 NOEP, communicated to you in November 2007, remain relevant and have been carried forward with added emphasis on onsite verification of management practices. In addition, other topics may be added in the future, as conditions change. We have been adding examination resources and increasing our oversight activities and onsite presence in institutions. You may expect this to continue in the rising risk environment faced by the FCS.

The general economy and financial marketplace are experiencing unprecedented times and considerable volatility, which have affected the risk profile of the agricultural sector. Many of the agricultural lending risk factors have been further exacerbated by the recent turmoil and lack of liquidity in the financial markets. Funding spreads for System debt over U.S. Treasury debt issuances have widened following the events in the markets and the recent actions by the U.S. Treasury, the Federal Reserve and Federal Deposit Insurance Corporation, which were designed to address systemic liquidity issues. As a result of recent market events, it has become more difficult and costly for the System to meet term funding needs. Additionally, as the result of market disruptions, raising capital in the current environment will be a significant challenge for all financial institutions, including the FCS. In light of the current events in the financial markets, your management and oversight of lending programs, funding, earnings, liquidity, and capital positions are critical to ensure that they remain sound in all material respects. Boards and their appropriate committees should step up reporting and oversight of management actions in these uncertain and crucial times.

The risks posed by the current environment are a threat to the condition of many System borrowers. These, combined with the rapid asset growth experienced by many FCS institutions in recent years, can strain financial institutions' personnel, risk management systems, internal controls, and capital. As part of our continuing communications with the System, we issued a May 9, 2008 Informational Memorandum that outlines our oversight plans and examination activities related to asset growth, along with information on "best practices" we have observed for institutions experiencing rapid growth. We urge you to review that memorandum in light of the emerging developments.

We identify below several areas focused on credit risk and capital management that we will emphasize in the coming year. In addition, several other oversight and examination activities discussed in greater detail in the Attachment to this memorandum are planned for FY 2009.

- ***Internal Audit and Credit Review Programs:*** Strong, independent internal controls are essential for safe and sound operations. Internal audit and credit review programs are critical components of an institution's internal control environment. An essential part of board governance carried out by the Audit Committee is the oversight of these programs. Audit Committee oversight must provide the board with reasonable assurance that risk is accurately and timely identified and managed. Accordingly, examiners will evaluate key aspects of Audit Committee operations. Examinations will also include increased onsite testing of assets to determine whether management has implemented sufficient risk identification systems and controls to appropriately manage existing and emerging risks. Examiner evaluation and testing will be emphasized for institutions experiencing rapid growth, having significant concentrations, or entering into new markets or business lines.

- ***Portfolio Risk and Stress Analysis:*** We will focus attention on risk identification, stress testing, portfolio management, underwriting, concentration limits, loan pricing, and other techniques employed by institutions to proactively identify, quantify, and manage risks. We will collect information on institutions' portfolio management and stress testing practices and capabilities through ongoing institution oversight and examination activities. Each FCS lender is expected to perform stress tests on its portfolio and develop various scenarios and plan appropriate responses should events unfold as assumed in those scenarios.

- ***Allowance for Loan Losses (ALL)***: Emerging risks in the general and agricultural economic environment indicate that institutions need to carefully consider the adequacy of their ALL to absorb probable and estimable losses. While historical loss experience is important in estimating current loss exposure, institutions should carefully analyze current conditions that have most likely increased the probability of losses. We will closely review the ALL methodology and the adequacy of the ALL.

- ***Shared Assets:*** In 2008, our shared assets efforts focused on coordinating with System institutions to gather additional information to identify credit and counterparty risk at the entry point into the System. For FY 2009, we will continue to obtain and analyze Systemsupplied information on shared assets to assess notable risk elements and facilitate OE's identification of the System's shared credit exposures. We will identify the "lead lender," other regulators' shared national credit evaluations (where available), and other pertinent information to promote timely and efficient identification of risk. Targeted shared asset reviews will address underwriting, servicing, and representations and warranties of the originating lender, as well as adequacy of the purchasing institutions' due diligence. We will have periodic communications with the System, as necessary, to address identified or prospective risks.

- ***Capital Management:*** As noted previously, the current market environment may limit access to capital, and we expect this to cause many System institutions to reassess their capital and business plans. Specifically, boards will need to determine whether current loan growth strategies can be adequately capitalized. As such, we will continue to discuss capital related issues with System representatives and analyze capital trends, patronage and dividend programs and strategies to determine appropriate capital management in FCS institutions. This activity is in response to an increasing risk environment and the impact that significant asset growth has had on capital ratios; the increased use of preferred stock, Farmer Mac standbys, and securitizations to manage capital ratios; and the increasing use of economic capital models.

In addition, while carrying out the credit risk-related activities, examiners will have a special interest and maintain a focus on collateral risk (especially loan-to-value ratios in the mortgage portfolio) and eligibility and scope of lending compliance.

Please distribute copies of this memorandum to your board and discuss its contents with the Chairman of your Audit Committee 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:

CEO Farm Credit Council
CEO Farm Credit Council Services

Other FY 2009 Oversight and Examination Activities

Investments and Liquidity: The recent turmoil in financial markets is having a direct impact on investments held by System banks for liquidity purposes. Credit ratings have been downgraded on some investments, rendering them ineligible under existing regulatory authorities. These downgrades have prompted the banks to submit plans to FCA for approval to hold these investments until maturity or until market conditions improve. Also, banks have experienced unrealized losses on their investments and have recognized a small amount of other than temporary impairment. The objectives of this activity are to closely monitor developments in the System banks' investment portfolios and implement supervisory strategies to ensure banks deal with risks related to the changing financial landscape. You may expect OE's Capital Markets Specialists to maintain frequent contact with each bank to monitor changing investment conditions, liquidity levels, and market access.

Counterparty Risk: System institutions are increasingly engaging in financial and credit transactions and operational services with both System and Non-System counterparties. As such, it is important to accurately measure and effectively manage exposure to counterparties. It is equally important that the System, as a whole, be able to assess its combined exposure to material counterparties. We will continue discussing with System representatives and individual institutions the importance of information systems and control processes to manage counterparty risks. We expect all institutions to conduct sensitivity analysis on earnings and/or capital impact should those counterparties be unable to perform as agreed.

General Financing Agreements (GFAs): In the face of potentially rising risks to banks from direct loans to their affiliated associations, it is critical that GFAs provide the framework and authority to respond to this risk in a timely, adequate, and proactive manner. This review will provide insight into whether banks are effectively using underwriting standards and GFAs to manage their direct loan exposures. It will take into account the results of a planned joint review of these key funding documents by System bank credit management during FY 2009.

Information Technology: Our operations specialist examiners will evaluate System governance and control practices over an institution's technology service providers (TSPs). This activity, which will be conducted at selected institutions, will include evaluating the risk assessment, due diligence, contracting, and monitoring processes for TSPs.

Young, Beginning, and Small (YBS) Farmers: We continue to evaluate the effectiveness of the System's YBS lending programs. On August 10, 2007, FCA revised FCA Bookletter BL-040 (Bookletter) to provide additional guidance that clarifies available authorities in serving YBS farmers and ranchers. In October 2006 we issued Examination Bulletin 2006-2, which clarified the "Other Credit Needs" of part-time farmers, including YBS farmers. FCA will continue to work with boards and management as they consider the opportunity discussed in those documents, as well as other opportunities to better serve YBS farmers and ranchers. In select institutions, examiners will evaluate implementation of FCA regulations governing YBS lending.

Compliance with Consumer and Borrower Rights Regulations: We will continue to use the National Examination Activity (NEA) approach for examining compliance with consumer, borrower rights, and other similar regulations to assess System compliance with applicable laws and regulations. The NEA will involve a sample of institutions and will evaluate and test internal controls used to manage compliance risk. Regulatory compliance will be evaluated at other institutions as appropriate.