

# Farm Credit Administration

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## Information Memorandum



November 21, 2007

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

A handwritten signature in black ink, which appears to read 'Thomas G. McKenzie', is positioned to the right of the 'From:' line.

Subject: National Oversight and Examination Program for 2008

This memorandum provides you a summary of the Office of Examination's (OE) Fiscal Year (FY) 2008 National Oversight & Examination Program. It discusses oversight and examination focus areas and associated planned activities for FY 2008. We continue to emphasize a proactive, national approach for the oversight and examination of material risks and emerging issues in the Farm Credit System (System). It is our intent to carry out our program in a differential, risk-based approach.

Our risk-based approach recognizes the responsibility for ensuring satisfactory internal control systems rests with each institution's Board of Directors (Board) and management. Effective audit committees and audit and review programs are critical management systems; and, their effectiveness significantly impacts examiners' confidence in an institution's internal control environment. While we utilize, and often rely upon, audit and review programs, we periodically test specific areas to ensure the programs remain sound. We urge audit committees to consider the information in this memorandum as they review and approve audit and review plans.

As we conducted our assessment of Systemwide risks, we considered information from a variety of internal, external, and System sources to focus our oversight and examination efforts. Based on this information, we identified three areas that will be emphasized in the coming year:

**Asset Growth:** With the System's significant asset growth, OE staff will take steps to develop a better understanding of growth and the effect on System institutions. Rapid growth can strain financial institutions' personnel, risk management systems, capital, and internal controls. We previously provided information and guidance to the System on significant growth and corresponding

implications in a February 9, 2007, Informational Memorandum. Where rapid growth has continued over a sustained period, we will examine risk management practices and audit and review programs to ensure risk is properly identified and monitored, and prudently managed. We also have noted that questions regarding eligibility and scope of financing tend to surface in rapidly growing institutions. Where eligibility and scope of financing concerns arise, examination activities will focus on the adequacy of Board and management actions to ensure compliance with FCA regulations.

**Capital Markets Activity (Lending):** We plan to expand upon the initial Shared Assets National Examination Activity (NEA) that was completed in 2006. The 2006 NEA was a coordinated effort to assess risk, lending controls, due diligence practices, counterparty exposures, and reliability of reporting processes on the largest System exposures. In 2008, we plan to gather additional data and information and focus on credit and counterparty risk at the entry point into the System. Due diligence, underwriting, and representations and warranties given by the originating lender will receive special attention. Examiners also will focus on purchased assets and the adequacy of the purchasing institution's due diligence, reliance on lead lenders, and syndication and assignment activity. This activity also will test conformity with scope of financing regulations, including the financing of agricultural property transitioning to other uses. Eligibility determinations for similar entity transactions also will be tested. For institutions receiving recommendations from our 2006 Shared Assets examination, we will follow-up to assess progress. Lastly, we plan to look more closely at capital markets lending alliances that exist among some System institutions. We will evaluate the agreements, relationships, and the sufficiency of risk controls by institutions in these alliances.

**Internal Audit and Credit Review Programs:** Internal audit and credit review programs are a critical component of an institution's 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 and conduct periodic on-site testing of audit and credit review programs. Examiner evaluation and testing is especially critical for institutions experiencing rapid growth or entering into new markets or business lines. The frequency and depth of our examinations will vary depending on an institution's conditions and our confidence in the overall internal control environment.

In addition to the focus areas discussed above, several other oversight and examination activities are planned for FY 2008 (see Attachment for details). Using our national, differential and risk-based approach, our planned activities will include various oversight and examination strategies and communications tailored to each institution's unique needs.

Please distribute copies of this memorandum to your Board and discuss its contents with the Chairman of your Audit Committee. Copies would also be helpful to managers of 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](mailto:paulsenr@fca.gov)), or me at (703) 883-4277 ([mckenzie@fca.gov](mailto:mckenzie@fca.gov)).

Attachment

### **Other Oversight and Examination Activities Planned for FY 2008**

- ***Systemic and Portfolio Risks:*** Rapid increases in commodity prices and increases in input costs have created a more uncertain environment for agriculture and greater risk for lenders. For example, recent increases in commodity prices, such as for corn, appear to have been rapidly capitalized into real estate values. The rapid increases in real estate and commodity prices have increased input costs such as rent charges for many producers, as well as feed costs for livestock producers. Our on-going discussion with lending officials and our oversight activities will focus on the underlying systemic risks caused by rapidly increasing commodity prices, input costs, and agricultural real estate values. Our objective is to ensure institutions consider both the direct and indirect impact on their portfolios and respond appropriately to managing the potential risk arising from these sources. Examiners will assess whether boards and management have adequately considered these factors when assessing systemic and portfolio risks, performing portfolio analyses and shock scenarios, revising underwriting standards, establishing hold limits, and setting business plan goals.
- ***Enterprise-wide Counterparty Risk:*** System institutions are increasingly engaging in financial 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 discuss with System representatives and individual institutions the importance of information systems and control processes to manage counterparty risks.
- ***Capital Management:*** We plan to discuss capital related issues with System representatives and analyze capital trends and strategies to determine what future oversight and examination activities might be needed. This activity is in response to 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.
- ***Implementation of Governance Regulations:*** The System has continued to grow in complexity. The need for highly qualified boards of directors and transparency in reporting to stockholders and investors also continues to increase. Accordingly, we will continue to evaluate institutions' governance practices and compliance with FCA's governance regulations that became effective April 5, 2006.
- ***Implementation of Young, Beginning, and Small (YBS) Farmers Bookletter and Other Credit Needs Examination Bulletin:*** A revised FCA Bookletter BL-040 (Bookletter) was issued on August 10, 2007. This Bookletter provides additional guidance that would allow use of available authorities in serving YBS farmers and ranchers. We will work with boards and management as they consider the opportunity to better serve YBS farmers and ranchers. We also will work with institutions as they develop policies and implement guidance for financing the "Other Credit Needs" of part-time farmers as communicated in Examination Bulletin 2006-2, issued October 2006.

- **Information Technology (IT):** IT operations present the core operational risk faced by System institutions. Our IT Specialists will review both IT Audit and IT Governance (refer to FCA's Publication "Directors Role" Appendix E) at the banks, System IT service providers, and at selected large associations. In addition, we will be following up at all institutions on the adequacy of actions taken to address recommendations from the IT NEA report that was issued to System institutions in December 2006.
- **Compliance with Consumer and Borrower Rights Regulations:** OE will again use the 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.