Harvesting Change

Farm Credit Administration
Office of Inspector General
Management Challenges 2018

MANAGEMENT CHALLENGES

As part of the Farm Credit Administration's (FCA or Agency) annual Performance and Accountability Report, the Reports Consolidation Act of 2000 requires Inspectors General to provide a summary perspective on the most serious management and performance challenges facing the Agency. These challenges reflect ongoing vulnerabilities identified by the OIG over recent years as well as new and emerging issues that the FCA faces. The chart below summarizes the top management challenges. The pages following the chart provide more depth regarding each challenge and the Agency's progress in addressing them.

Examination and supervision program

Identifying and addressing risks in the Farm Credit System through effective examination and supervision to ensure the System remains safe and sound.

Information technology

Leveraging investments in information technology while maintaining a secure environment.

Human capital

Maintaining a well-trained, sustainable workforce while facing challenges in retirement eligibilities, workforce retention, and diversity.

Secondary market oversight

Providing effective and impartial oversight of the Federal Agricultural Mortgage Corporation (Farmer Mac) through FCA's Office of Secondary Market Oversight

CHALLENGE ONE: *EXAMINATION AND SUPERVISION PROGRAM*

A significant challenge for FCA lies in identifying and addressing risks in the Farm Credit System (FCS or System) through effective examination and supervision to ensure the System remains safe and sound.

The System continues to be impacted by changing risk conditions. Over the last number of years, net farm income has declined and price levels for key commodities have been low. Macroeconomic factors, such as changing interest rates and energy prices, will likely also impact risk in the System. Additionally, changing trade policies (including revised trade agreements and potential new tariffs) with several key U.S. partners will likely cause more volatility for agricultural products in the near future. FCS institutions must continue to be proactive and responsive to these risks. Working with borrowers and adapting to increasing risks while maintaining financial capacity will further increase the complexity of the System.

FCA's examination and supervision program must align with evolving threats, risks, and conditions. FCA uses a risk-based approach for oversight of the System. The Agency will require more sophisticated risk evaluation techniques to align with existing and emerging risk factors and identify and deter consequences with the greatest potential impact. Effective oversight will require using new technologies and developing new skill sets within the Agency. The control environment must also evolve to address increasing expectations associated with internal controls.

From time to time, more serious or persistent weaknesses require additional oversight activities. FCA must respond and intervene, when necessary, to protect the System. Effective examination and supervision requires prompt identification of unacceptable risks. Both internal and external factors can cause significant changes in condition in a short period of time. Corrective actions and follow-up are critical to preventing the escalation of issues that impact safety and soundness. The Agency must be agile to monitor and prevent such conditions to protect the System.

Agency Progress

FCA continuously works to address the challenges of its examination and supervision roles and responsibilities. The Office of Examination (OE) has issued Informational Memoranda with guidance for institutions.

An Informational Memorandum titled *Planning for LIBOR Phase-Out* (September 11, 2018), provides guidance on planning and preparing for the expected phase-out of the London Interbank Offered Rate. OE issued several Informational Memoranda concerning Regulation Z requirements, including one on *TILA-RESPA Rule Revisions* (August 10, 2018); one on *2016 Mortgage Servicing Rule Amendment* (May 2, 2018); and one on *Regulation Z Adjustment to Asset-Size Exemption Threshold and Military Lending Act* (March 8, 2018. Another Informational Memorandum titled *Regulatory Capital of Certain Centrally Cleared Derivative Contracts* (April 5, 2018) provides guidance regarding the regulatory capital treatment of certain centrally cleared derivative contracts. Another Informational Memorandum titled *Maximum Farm Credit System Bank Director Compensation for 2018* (January 23, 2018), provides the pay cap allowance in accordance with statute and regulation.

The Agency issued a Bookletter on *Strengthening Lending and Loan Servicing Controls* (March 8, 2018) that provides guidance on the Agency's expectation for FCS institutions to continuously assess their lending and loan servicing controls to ensure controls remain effective and comply with FCA regulation.

Each year, OE identifies National Oversight Plan risk topics that are emphasized in ongoing examinations and oversight activities. For Fiscal Year 2018, two risk topics were identified: *Portfolio Risk – Weathering the Storm and Internal Controls Over Financial Reporting*. Other areas of emphasis in the 2018 plan include stress testing and earnings trends/operating expenses. For Fiscal Year 2019, OE identified two risk topics: to concentrate on portfolio risk and how institutions are "navigating rough waters" and maintaining "three lines of defense" of internal controls (risk owners, risk management, and independent assurance). Another area of emphasis includes underscoring the importance of stress testing to Farm Credit System institutions.

Currently underway is an OIG benchmarking study on the organizational structure of OE as compared to the other Federal Financial Regulatory Agencies. The OIG also plans to address other challenges faced by the examination and supervision program, including a review of the Agency's oversight of internal controls and the Agency's progress in developing stress-testing applications.

CHALLENGE TWO: *INFORMATION TECHNOLOGY*

A significant management challenge for FCA is the ability to leverage investments in information technology (IT) while maintaining a secure environment.

Cybersecurity threats and vulnerabilities require an IT security program that is both realistic and forward-looking. The continuous challenge created by cybersecurity threats is highlighted by security incidents and data breaches involving both the public and private sector. Cybersecurity threats could have a direct impact on FCA and other government agencies' abilities to perform their missions. As such, it is imperative to prevent and respond to these types of attacks to ensure that the Agency can continue to perform its mission.

While cybersecurity threats are increasing, FCA is increasingly reliant on IT software to identify and analyze potential risks from the sensitive financial data that the Agency receives from the System. Hence, it is imperative that FCA has the necessary IT tools and staff to stave off cybersecurity threats and to operate more efficiently and effectively. At the same time, the Agency must be prudent and responsible with its spending. Finally, to be effective, FCA needs a well-trained staff that can successfully integrate new tools into its operations.

The successful implementation of IT provides FCA staff with the tools and skills that enable the Agency to continue to:

- Improve the quality and availability of financial data used to examine potential risks across the System without creating an undue burden on the System;
- Streamline business processes and build business intelligence to provide decision-makers with timely management information while coordinating with staff from multiple offices;
- Develop electronic recordkeeping and management capability for capturing, maintaining, and sharing institutional knowledge; and
- Protect and secure FCA information systems and data from ever-increasing external and internal threats.

Agency Progress

Over the past few years, FCA has invested in various IT tools to increase efficiency and effectiveness. FCA invested in analytical tools with the goal of improving risk identification in the System by analyzing System loan data. The Office of Information Technology (OIT) provided training for the new analytical tools.

FCA's risk-based information security program continues to mature as it continuously identifies areas to strengthen and improve security. The OIT supplemented its staff with an information security contractor to assist with further development of its security program.

The OIG performs an annual evaluation of FCA's compliance with the Federal Information Security Modernization Act of 2014. Recently, the OIG conducted a benchmarking study of the OIT and its use of contractors. Our benchmarking study revealed OIT's office budget increased 20% from FY 2016 to 2018, and OIT's budget for other contractual services increased 48% from FY 2016 to 2018. When compared to the IT budgets of the other federal financial regulators, FCA's IT budget, as a percentage of the Agency budget, falls in the middle of the benchmarked agencies, and FCA's use of contractors was the lowest of the other agencies.

Looking ahead, the OIG will continue to focus on the operations of OIT to ensure that it is receiving value for its increased use of contractors and effectively utilizing its full-time staff.

CHALLENGE THREE: *HUMAN CAPITAL*

A significant management challenge for FCA is maintaining a well-trained, sustainable workforce while facing challenges in retirement eligibilities, succession planning and training, and diversity.

Employees are FCA's most valuable asset. The Agency must continue to invest in its employees and their development. FCA's success depends on its workforce. When the workforce changes, the disruption can affect the Agency. FCA continues to have a significant amount of retirement eligibilities. Agency staffing currently has a dearth of employees poised to step into the shoes of departing managers and supervisors. This presents a challenge for the Agency because of key personnel dependencies and a loss of institutional knowledge when these individuals retire.

With the loss of experienced managers and supervisors, the Agency faces a challenge in replacing key personnel. It is important for the Agency to have succession plans in place to pass down the knowledge and experience gained throughout employees' careers and to reduce dependencies. Workforce training and developing takes a significant investment of resources. Using tools, such as data analytics, can help the Agency identify training gaps. Succession management planning and career development can also be accomplished through job sharing, as well as detail and micro-assignment opportunities. Mentoring programs are also an effective way of preparing employees for management positions.

Increasing diversity also remains a human capital challenge for FCA. A diverse staff brings different perspectives to problem-solving, enhances the Government's duty to be an inclusive employer, and enriches the Agency's ability to effectively regulate. The Agency must continually assess and deploy strategies to reach its goals for diversity and inclusion. It can do this by using various tools that identify and reduce potential barriers to diversity and inclusion, enhance outreach, evaluate the Agency's recruitment data, and heighten awareness through programs that support diversity and inclusion.

Agency Progress

The Agency's Strategic Plan includes goals and performance measures related to human capital. Strategic objectives address maintaining a skilled, motivated workforce; ensuring adequate succession planning and knowledge transfer; and encouraging an engaged, diverse, and ethical workforce. FCA measures its success towards human capital goals based on employee outreach efforts and the results of the annual employee satisfaction surveys. The Agency also provides benefits and employee programs to attract and maintain a talented diverse workforce. In 2018, FCA accepted applications for its Student Loan Repayment Program. FCA's learning office also provides numerous online and in-person training resources to support technical skills, work/life balance, and managerial competencies.

The OIG has completed various audits and inspections relating to human capital at FCA. This year, the OIG completed physical security inspections of FCA headquarters and field offices. Looking ahead, the OIG will continue to focus on the succession planning and training efforts of the Agency.

CHALLENGE FOUR: *SECONDARY MARKET OVERSIGHT*

A significant management challenge for FCA is to ensure that it effectively and impartially regulates the Federal Agricultural Mortgage Corporation (otherwise known as Farmer Mac) through the Office of Secondary Market Oversight (OSMO). Farmer Mac is a stockholder-owned, publicly-traded company that was chartered by the United States federal government in 1988 to serve as a secondary market for agricultural credit by increasing access to, and reducing the cost of, capital to American agriculture and rural communities. Although Farmer Mac is part of the FCS, its secondary market mission is unique among FCS institutions. Farmer Mac's customer base is diverse, nationwide, and includes commercial and community banks, insurance companies, non-bank lenders, agricultural funds, rural utilities and other FCS institutions. Many of Farmer Mac's customers directly compete with other FCS institutions for a share in the agricultural lending market.

FCA, acting through the OSMO, examines, regulates, and supervises the activities of Farmer Mac to ensure its safety and soundness and the accomplishment of its public policy purpose as authorized by Congress. It also ensures that Farmer Mac complies with applicable laws and regulations, and it manages FCA's enforcement activities with respect to Farmer Mac.

Under the Farm Credit Act of 1971, as amended (Act), OSMO was established with a degree of independence not shared by other FCA offices. For instance, unlike most other FCA office directors, the OSMO Director reports directly to the FCA Chairman rather than the Chief Operating Officer. The Act also provides that the supervision of the powers, functions, and duties of Farmer Mac is performed, to the extent practicable, by personnel who are not responsible for the supervision of the banks and associations of the FCS. To fulfill its duties, OSMO uses examiners who also examine FCS banks and associations. Therefore, OSMO is continually challenged to ensure that it fulfills its oversight role free of conflicts of interest or undue influence from those also responsible for the supervision and regulation of the FCS banks and associations.

It is a challenge for OSMO to conduct its oversight and examination activities with a relatively small and independent staff (approximately 6 employees), while balancing resources sourced from FCA's Office of Examination responsible for supervision of FCS banks and associations. OSMO staff must have the necessary knowledge, skills, and training to understand the unique and complex mission, secondary market activities, and business model and capitalization of Farmer Mac. Further, because Farmer Mac is a publicly-traded company, OSMO staff must understand the market forces and reputational risks that can potentially affect Farmer Mac's safety and soundness. Advancements in data gathering, technology, and analytics that aid OSMO with risk measurement, management, and assessment, coupled with appropriate specialized training, can enhance FCA's ability to oversee Farmer Mac as it grows in scale and complexity. This will be particularly important in an environment that may present more credit, trade, and interest rate challenges to farmers, ranchers, rural communities and their lenders.

Finally, OSMO is further challenged by Farmer Mac's complicated corporate governance structure and changes in leadership. The Farmer Mac board is made up of 15 directors, including five Presidential appointees and ten directors representing the different classes of stockholders. Over the last decade, Farmer Mac has experienced many changes among members of its executive management team that result in disruptions in Farmer Mac operations. OSMO's oversight role is made more difficult in ensuring the continued safety and soundness of Farmer Mac in the face of its large board representing diverse interests and the changes to its executive management.

Agency Progress

In its oversight role, OSMO implemented regulatory and other changes related to Farmer Mac. In 2018, OSMO revised its Risk Based Capital Stress Test for Farmer Mac to reflect changes to the corporate tax code. FCA also revised regulations that define the criteria a nonprogram investment must meet for Farmer Mac investment. These changes were made in addition to OSMO's supervision and safety and soundness reviews of Farmer Mac.

This year, the OIG completed an audit to assess staffing arrangements and the reporting process for OSMO. Our review included recommendations to improve OSMO's processes and increase transparency. Because of our review, OSMO revised a directive to address conflicts of interest. In addition, OSMO developed a conflict of interest questionnaire and added a conflict of interest statement to rotational assignment agreements. OSMO also created a directive on the Farmer Mac assessment procedures. FCA's Office of the Chief Financial Officer documented methodologies used to calculate Farmer Mac's assessments. Lastly, based on our review, the FCA Board created a delegation addressing the OSMO Director's reporting relationship with the FCA Board.

Going forward, the OIG will review other aspects of OSMO oversight. As the complexity of Farmer Mac increases, OSMO will need to ensure it maintains appropriate readiness to evaluate safety and soundness. To achieve its mission, OSMO may require increased resources and technical skills, which will present additional challenges for the Agency.