

**FARM CREDIT ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL**

***REPORT OF  
INSPECTION***

***Cash Management  
and  
Investment Practices***

***A00-07***

***September 28, 2000***



September 27, 2000

The Honorable Michael M. Reyna  
Chairman and Chief Executive Officer  
Farm Credit Administration  
McLean, Virginia

Dear Mr. Reyna:

We have completed our inspection of the Farm Credit Administration's (FCA or Agency) Office of Resources Management's Cash Management and Investment Practices. Our objective was to evaluate the cash management and investment practices for funds garnered mainly by the Agency assessment of Farm Credit System institutions.

Section 5.15 of the Farm Credit Act of 1971, as amended, limits the Agency's cash management and investment practices but the Agency does have management discretion over them. The FCA Board has adopted a policy for exercising this discretion. We found several areas that should be improved, including collection and deposit practices, the process of making investment choices, and compliance with Board policy. We also identified some potential improvements through our benchmarking the cash management and investment practices of the Farm Credit System Insurance Corporation.

We conducted this review in accordance with the *Quality Standards for Inspections* issued by the President's Council on Integrity and Efficiency. We performed our fieldwork from May 2000 to July 2000 at FCA headquarters in McLean, Virginia. An entrance conference was held on May 17, 2000 and an exit conference was held on September 6, 2000. The Office of Inspector General and management have agreed on the actions to be taken to resolve all issues included in this report.

Respectfully,

A handwritten signature in black ink, appearing to read 'Eldon W. Stoehr', is written over the typed name.

Eldon W. Stoehr  
Inspector General

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## **BACKGROUND**

The Farm Credit Administration (FCA or Agency) is an independent Federal financial regulatory agency of the United States Government. It has regulatory, examination, and supervisory responsibilities for the Farm Credit System (FCS or System) banks, associations, and related institutions.

The FCA is allowed under Section 5.15 (FCA's Operating Expenses Fund) of the Farm Credit Act of 1971, as amended, (Act) to determine:

- The cost of administering the Act for the subsequent fiscal year.
- The amount of assessments required to pay administrative expenses, taking into consideration the funds already contained in the administrative expense account and needed to maintain a necessary reserve.
- The amount of assessments that will be required to pay the costs of supervising and examining the Federal Agricultural Mortgage Corporation.

These funds have to be held in the Treasury of the United States (Treasury) in the FCA's Administrative Expense Account.

The Agency has the following discretion over funds maintained by Treasury:

- At the request of the FCA, the Treasury can invest and reinvest such amounts contained in the Administrative Expense Account that are in excess of the amounts necessary for current expenses of the FCA.
- All income earned from such investments and reinvestments is deposited in the Administrative Expense Account.
- Investments must be made in public debt securities with maturities in line with the needs of the Administrative Expense Account, and bearing interest at rates determined by the Treasury, taking into consideration current market yields on outstanding marketable obligations of the United States of comparable maturities.

Interest income earned by the Agency on the balance of these funds may be used to reduce the total assessment imposed on FCS institutions. FCA earned \$870,000 in interest income on fiscal year 1999 investments that averaged \$14.4 million. The Agency's new accounting system has not been able to provide information about the average uninvested balance nor average yield for the investment portfolio since its implementation in late 1998. We used information from the Fiscal Resources Division (FRD) quarterly cash flow and investment analysis in arriving at our computations.

## OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this inspection was to evaluate the Agency's cash management and investment practices. To meet this objective we: 1) analyzed FCA's cash flow for the past two years to identify opportunities to improve the collection and/or payment of funds; 2) reviewed FCA's investment transactions to evaluate whether the invested portion of available funds and the yields of specific investments produced the best available earnings for the Agency; 3) compared investment practices to the Board's policy to conclude whether the Board's expectations are being met; and 4) benchmarked the Agency's investment practices and performance against those of the Farm Credit System Insurance Corporation (FCSIC).

## FINDINGS AND AGREED UPON ACTIONS

### Collections received through the mail have not been deposited in a timely manner.

FRD has not made timely deposits of collections received by mail. Even though the majority of FCS institutions pay their assessments electronically, the Agency still physically handles a significant number of checks each quarter because 59 institutions, or 33 percent of all FCS institutions, continue to send in their payments by mail. Depositing practices for these mailed payments were not always in accordance with Agency policy. This increased the potential for loss of the deposits themselves.

FRD's written procedures require deposits to be made at least twice a week or whenever collections on hand exceed \$1,000. According to FRD management, the informal FRD policy is for deposits to be made at least once a week or whenever collections reach \$5,000. We found that actual practices do not conform to either FRD written procedures or management's less stringent unwritten expectations; i.e., as checks over \$5,000 were not deposited for several days and deposits were not always made weekly. Review of deposit records for December and March showed;

- three checks totaling \$59,000 were deposited six days after their receipt,
- four checks totaling \$30,000 were deposited four days after receipt,
- one check for \$24,000 was deposited five days after receipt,
- one check for \$5,000 was deposited 13 days after receipt, and
- one check for \$1,100 was deposited 10 days after receipt.

Timely depositing has recently been added to the responsible employee's performance plan in an attempt to improve the division's performance in this area.

Electronic payment of assessments by FCS institutions makes those collections immediately available for investment and eliminates the administrative processing of collections received through the mail. While the Agency has previously requested nonparticipating FCS institutions

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to change to electronic payment, as stated above about one third continue to pay by the traditional mailed check method. The Agency should redouble its efforts to persuade all institutions to pay electronically.

Agreed Upon Actions

1. *FRD management will strengthen internal controls to ensure timely deposit of payments and conformance with established procedures.*
2. *FRD management will update office procedures establishing accountabilities for making deposits.*
3. *FRD management will continue efforts to convert the FCS institutions to making assessment payments electronically.*

There has been modest improvement in Agency investment practices but more is needed.

FCA's current strategy is to place the bulk of its investments in overnight funds with only a small portion of the portfolio (15-20%) placed in instruments with longer maturities. The portion of the portfolio with longer maturities includes instruments with maturities from six months to two years and they are "laddered" to mature at six-month intervals. Individual investments are limited by FRD practice to instruments that mature within two years. The Agency has slowly increased the proportion of longer maturities within the portfolio, subsequent to a September 1996 Office of Inspector General audit. Prior to that audit, all investments had maturities of less than 30 days. The practice of investing primarily in overnight instruments assumes an inverted yield curve environment; i.e., when higher interest rates are paid on short term investments than long term investments. Inverted yield curves are abnormal and usually are of a short duration.

Unwavering adherence to the practices described above, without considering current market conditions, has caused the Agency to pass up significant interest income opportunities when higher yields were available on investments with longer maturities. In December 1997 the Agency rolled over a \$543,000 investment into a one-year instrument when a two percent premium was available on a two-year instrument. The Agency forfeited \$23,000 in interest earnings by that action and that loss was compounded by the fact that the one-year investment matured and was reinvested in a falling interest environment. Investing in two-year maturities is well within the parameters of the Board's cash and liquidity management policy.

Conversely in January 2000, a \$1 million investment was made with a two-year maturity that yielded only .25 percent premium over the overnight funds rate. This produced only a \$5,000 increase in earnings but committed a large amount over the two years in an environment of increasing interest rates. FRD staff indicates that there is no criteria for deciding between overnight funds and longer term investments nor are interest rate forecasts considered in

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investment decisions. FRD's assertion that liquidity is the overriding investment objective is contradicted by this transaction.

There are no back-up procedures for many investment functions; particularly, alternative investment instructions did not exist to communicate the information required for investment of overnight funds during a recent power outage. As a consequence, the Agency lost \$2,100 in interest income because that transaction could not be executed.

Current investment practices limit the investment portfolio to instruments with no more than a two-year maturity even though the Board policy allows up to 50% of the portfolio to be in instruments with maturities longer than two years. Current practice precludes the Agency from taking advantage of occasional "sweet spots" in the yield curve to generate more interest income. Recent historical data indicates that an additional half percent could be added to the average investment yield by extending maturities an additional one to three years. This would increase investment income \$5,000 annually for each \$1 million investment and, based on the historical investment balances, annual interest income for the entire portfolio would increase by approximately \$70,000.

*Agreed Upon Actions*

4. *FRD management will develop backup processes to ensure the timely and effective investment of Agency funds.*
5. *Adjust the Agency investment strategy to appropriately balance market conditions and cash flow requirements in all investment decisions for the entire investment portfolio.*
6. *As cash flow needs permit, lengthen the maturity of the investment portfolio when compelling market opportunities exist beyond the self imposed two-year time horizon.*

**Management is not complying with the Board's policy statement on Agency cash and liquidity management.**

Agency cash and liquidity management requirements are established in FCA Board Policy Statement Number 66. However, some aspects of this policy statement have not been followed, mainly on the reporting requirement that says: "Quarterly, the COO shall report to the FCA Board on the liquidity position of the Agency and the composition of the investment portfolio." The quarterly reporting was discontinued with the advent of the Agency's new accounting system in late 1998, which could not provide quarterly reporting for the Agency's liquidity position and the composition of the investment portfolio. Since then, FRD has been following an FRD developed draft policy statement, which calls for reporting to the Board periodically on the liquidity position and composition of the investment portfolio.

**Agreed Upon Action**

7. *FRD management will propose an update to the Board's Policy Statement on Cash and Liquidity Management for the Board's approval.*

**FCSIC investment practices offer opportunities to improve FCA's practices.**

Our benchmarking of FCSIC's investment practices and performance confirmed that the FCA has shadowed certain positive aspects of the FCSIC. During the past two years the FCA has been following a strategy of increasing its "barbell approach" (overweighing the invested amount at each end of their investment time horizon) for investing its excess reserves. This has been done by increasing the amounts invested in overnight funds (since December of 1998) and increasing the amount of investments with maturities in the six-month to two-year time frame. The increased use of overnight funds was consistent with FCSIC's approach. These actions highlighted a shortening of the overall maturity level of the portfolio by using overnight funds to take advantage of the inverted yield curve that existed. However, the following FCSIC investment practices offer opportunities to improve FCA's investment function:

- All investment decisions are adjusted for market conditions.
- Redundant systems are in place to ensure investments are always made.
- FCSIC focuses on yield rather than strict adherence to strategy and therefore takes advantage of pricing opportunities in the yield curve.
- FCSIC uses an investment committee for investment decisions.

FCSIC's investment performance suggests that adoption of the above items would also benefit the Agency's overall investment function. If the size of the Agency's investment portfolio makes some of these aspects impractical, the Agency could consult FCSIC on such issues.

**Agreed Upon Action**

8. *FRD will utilize FCSIC as a source of investment advice for the Agency's investment decisions and practices.*