Audit Report

The Farm Credit Administration's Office of Secondary Market Oversight A-17-03

Auditors
Sonya Cerne
Tori Kaufman

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The Honorable Dallas P. Tonsager, Board Chairman  
The Honorable Jeffery S. Hall, Board Member  
The Honorable Glen. R. Smith, Board Member  
Farm Credit Administration  
1501 Farm Credit Drive  
McLean, Virginia 22102-5090

Dear Board Chairman Tonsager and Board Members Hall and Smith:

The Office of Inspector General (OIG) completed an audit of the Farm Credit Administration’s (FCA or Agency) Office of Secondary Market Oversight (OSMO). The objective of this audit was to assess the staffing arrangements and reporting process for OSMO. We found that staff resources are planned and projected each year and staff hours are tracked by office and by employee. An annual assessment amount is calculated and communicated to the Federal Agricultural Mortgage Corporation (FAMC).

We identified opportunities to improve OSMO’s processes and increase transparency. In response to our report, OSMO agreed to:

1. Revise OSMO Office Directive 3 to include the risks of specific conflicts of interest or bias from using examiners and other staff that also review, or provide services relating to, Farm Credit System associations and banks.

2. Require independence documentation from rotational staff to mitigate the risks of conflicts of interest or impartiality concerns.

3. Create an office directive on the assessment process roles and responsibilities.

The Office of the Chief Financial Officer agreed to:

4. Document the methodology and process used to calculate the FAMC assessments to include:
   
   a. details on how the Agency arrives at direct, indirect, overhead, and blended rates.
b. communicating quarterly reports showing charges against annual FAMC assessments to the OSMO Director for review and confirmation.

c. a method to clearly separate the costs of shared OSMO employees also performing FCA work from the assessments to FAMC.

The Office of the Board agreed to:

5. Document the reporting relationship between the OSMO Director and the FCA Board including delegations, supervisory relationships, and FCA Board oversight involvement of the OSMO Director.

OSMO and OCFO initiated corrective actions and we consider the Agreed-Upon Actions 1-4 resolved and closed. Agreed-Upon Action 5 remains open.

We appreciate the courtesies and professionalism extended by FCA personnel to the OIG staff. If you have any questions about this audit, I would be pleased to meet with you at your convenience.

Respectfully,

Wendy R. LaGuarda
Inspector General

Enclosure
The Farm Credit Administration (FCA or Agency) is an independent Federal agency responsible for regulating, examining, and supervising the Farm Credit System and the Federal Agricultural Mortgage Corporation (FAMC).

FAMC is a government-sponsored enterprise with the mission of providing a secondary market for agricultural real estate mortgage loans, rural housing mortgage loans, and rural utility cooperative loans. FAMC is regulated, examined, and supervised by FCA through the Office of Secondary Market Oversight (OSMO).

The objective of this audit was to assess the staffing arrangements and reporting process for OSMO. We found that staff resources are planned and projected each year and staff hours are tracked by office and by employee. An annual assessment amount is calculated and communicated to FAMC.

In assessing staffing arrangements and the reporting process for OSMO, we identified opportunities to clarify the process and improve documentation.

- The current structure of OSMO staffing that utilizes staff from other FCA offices necessitates increased due diligence to mitigate against conflicts of interest and impartiality concerns.
- The FAMC assessment process should be developed, documented, and communicated to increase accuracy, fairness, and transparency of costs associated with FAMC.
- The reporting relationship for the OSMO Director to the FCA Board should be formalized and kept within the stipulations and spirit of the Farm Credit Act and Agency legal interpretation.

The Agency agreed to take five actions in response to our report to increase transparency and improve processes related to OSMO. The Agency completed corrective actions for four of the five actions, which are considered resolved and closed. One remains open.
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The Farm Credit Administration (FCA or Agency) is an independent Federal agency responsible for regulating, examining, and supervising the Farm Credit System (FCS or System) and the Federal Agricultural Mortgage Corporation (FAMC). FCA ensures that System institutions and FAMC are safe, sound, and dependable sources of credit and related services for all creditworthy and eligible persons in agriculture and rural America.

FAMC is a government-sponsored enterprise with the mission of providing a secondary market for agricultural real estate mortgage loans, rural housing mortgage loans, and rural utility cooperative loans. FAMC is regulated, examined, and supervised by FCA through the Office of Secondary Market Oversight (OSMO).

OSMO was established by the Food, Agriculture, Conservation, and Trade Act Amendments of 1991 (Public Law 102 – 237). Section 8.11 of the Farm Credit Act of 1971, as amended (Act), Supervision, Examination, and Report of Condition, describes OSMO authorities and requirements.
Each year, OSMO conducts an examination of FAMC to evaluate its safety and soundness, compliance with applicable laws and regulations, and mission achievement. The examination includes a review of FAMC’s:

- Capital adequacy,
- Asset quality,
- Management performance,
- Earnings,
- Liquidity, and
- Sensitivity to interest rate risk.

As part of its supervisory duties, OSMO also performs a variety of other examination and oversight activities, in addition to the annual report of examination. Such activities focus on all aspects of FAMC operations. For example, the capital plan assessment includes a review of regulatory capital planning requirements, capital policy, capital-adequacy modeling, and stress testing methodologies. The loan and servicing review includes the evaluation of risk identification, underwriting, loan servicing, and data integrity both at FAMC and its central servicers. Following the activities, OSMO is authorized to issue activity letters providing a summary of scope, conclusions, findings, and recommendations, if warranted.

OSMO also gathers information from FAMC and other sources on an ongoing basis about the general and agricultural economic conditions used to identify, monitor, and evaluate emerging risks. OSMO also performs a quarterly review and risk assessment of FAMC based on FCA’s Financial Institution Rating System criteria. Finally, under its regulatory authority, OSMO develops and issues policies and regulations, with the approval of the FCA Board, to ensure FAMC’s safety and soundness.

OSMO is currently staffed with a Director, two Associate Directors, one Senior Financial Risk Analyst, and a shared Administrative Specialist. OSMO currently supplements its staff each year with examiners from the Office of Examination (OE) to assist with the FAMC examination and with OSMO’s supervisory responsibilities. OSMO also receives service from various offices in FCA, such as legal services from the Office of General Counsel (OGC) and information technology services from the Office of Information Technology (OIT), as needed.

FAMC pays assessments to cover the costs of its regulation, supervision, and examination by FCA, as required by section 8.11(d) of the Act. FCA’s Office of the Chief Financial Officer (OCFO) calculates assessments based on projected needs and tracks OSMO expenses quarterly. OCFO works with OSMO to understand staffing needs and other inputs included in the assessment calculation.
The objective of this audit was to assess the staffing arrangements and reporting process for OSMO. To further understand staff utilization, we also reviewed how the Agency assesses FAMC for the costs of its regulation, examination, and supervision. We found that:

- OSMO plans and projects staff resources each year;
- Staff hours devoted to OSMO are tracked by office and by employee;
- OCFO calculates an annual assessment amount and communicates the amount to FAMC;
- OSMO evaluates staffing during planning cycles and projects future needs; and,
- The Agency recently made changes to the OSMO Director reporting relationship to the FCA Board.

In assessing staffing arrangements and the reporting process for OSMO, we identified opportunities to clarify the process and improve documentation. These changes will improve transparency and the overall control environment.

### Staff Utilization

To fulfill mission requirements, OSMO needs staff to perform regulatory, supervision, and examination work over FAMC. OSMO does not currently perform required work solely with its own staff due to its small size and the need for specialized expertise in certain areas on an intermittent basis. By using other FCA staff, the cost calculations for FAMC assessments become more difficult to allocate, both increasing the need for transparency of such costs and the need to mitigate potential conflicts of interest and impartiality concerns.

### Staffing Structure

OSMO was originally established with minimal staff and a Director. Currently, OSMO continues to maintain a small staff of a shared administrative specialist and four other full-time employees, including the Director. OSMO uses supplemental staff from OE to complete its annual examination of FAMC and assist with OSMO’s supervisory initiatives. For certain oversight activities that require specialized experience, OSMO may obtain third party contracted staff in addition to staff from other FCA offices. Specialized expertise may be needed in areas such as stress test models and methodology and technical research and analysis on financial or regulatory matters.

FAMC reported in its fiscal year (FY) 2016 Annual Report that its assets have grown by an average annual rate of more than 12 percent over the last 17 years. In fact, the annual report states business volume went from $2.3 billion in 1999 to $17.4 billion in 2016. In addition,
according to its 10K filings, from 2011 to 2017, FAMC increased its staff by 26 people, which is about a 42 percent increase.

In December 2017, OSMO announced efforts to expand staff with four individuals selected for OSMO rotational assignments. One individual is assigned to OSMO as an examiner-in-charge for the rotation. OSMO also gained an assistant examiner-in-charge and two other staff on limited rotations for career development opportunities.

OSMO primarily uses OE examiners to supplement its small staff. For FAMC activities and examinations, OSMO may also need specialized staff to perform mission requirements. OSMO receives legal services from OGC and limited services from other offices, such as OIT. In addition, OSMO shares an administrative specialist with the Office of Equal Employment Opportunity and Inclusion.

Based on cost assessments completed by the OCFO, staff allocations from the various FCA offices to OSMO activities were as follows for FYs 2015 and 2016:
For FY 2015, OSMO activities accounted for about 6.6 full time equivalents (FTEs) (2,080 hours a person) and 6.4 FTEs for FY 2016. For both years, designated full-time OSMO staff accounted for 4.7 FTEs and 4.6 FTEs, respectively.

Currently, FCA has elected to supplement staff for OSMO with OE examiners who also tend to be responsible for examining FCS banks and associations. Section 8.11(f) of the Act, states:

The Farm Credit Administration Board shall ensure that

(1) The Office of Secondary Market Oversight has access to a sufficient number of qualified and trained employees to adequately supervise the secondary market activities of the Corporation [FAMC]; and

(2) the supervision of the powers, functions, and duties of the Corporation [FAMC] is performed, to the extent practicable, by personnel who are not responsible for the supervision of the banks and associations of the Farm Credit System [emphasis added].

The time sheet reports received from OAS showed that 27 different OE examiners charged time to various OSMO activities during FY 2015 and 18 different examiners charged time to OSMO activities during FY 2016. However, we note that OSMO is also used as a career development opportunity for other examination staff due to the unique nature of FAMC and its specialized accounting, loan, and credit activities. Examiners also may be assigned to OSMO for a short
time. Many of the OE staff in FYs 2015 and 2016 charged less than 80 hours for the year to OSMO.

The dual role of OE examiners having to examine both the secondary market as well as the market participants (FCS banks and associations), could create conflicts of interest or impartiality concerns. Such real or perceived conflicts of interest or biases could stem from the fact that OE examiners spend most of their time examining FCS banks and associations and a small portion of their time examining FAMC. Given this imbalance, there is a potential danger that OE examiners are more partial to System bank and association concerns when examining issues involving FAMC.

In addressing the potential conflicts of interest or impartiality concerns with the placement of OSMO in FCA, a 2002 FCA legal opinion recommended that FCA continue to supervise FAMC, to the maximum extent practicable, through employees who are not responsible for the supervision of the System banks and associations, as noted in the Act. Fifteen years later, and despite the growth of FAMC, a portion of the OSMO staff still comes from other FCA offices rather than having a workforce that is independent from those who also regulate, supervise and examine the FCS banks and associations.

When OSMO uses staff from other offices, OSMO does not require such staff to certify that no conflicts of interest or impartiality concerns are an issue. OSMO’s Office Directive on Examiner Ethics addresses the overall Agency’s policy on examiner ethics and disclosure of information, but does not address the potential conflicts of interest or impartiality concerns that may exist with examiners who review both FCS banks and associations and FAMC. Having such documentation in place would help to ensure that shared staff are aware of these potential conflicts and are able to certify that they will remain impartial when engaging in OSMO matters.

**Cost Calculations**

To determine how staff utilization affects FAMC costs, we reviewed the Agency’s cost assessment process. FCA regulation 607.4(b), states:

> Assessment of Federal Agricultural Mortgage Corporation. The FCA shall assess FAMC for the estimated cost of FCA’s regulation, supervision, and examination of FAMC, including reasonably related administrative and overhead expenses. FAMC’s assessment may be adjusted periodically to reflect changes in the FCA budget and to reconcile differences between FAMC’s assessment and FCA’s actual expenditures for regulation of FAMC in the prior fiscal year.
FAMC is unique. Accordingly, FAMC’s assessments are not calculated using FCA’s assessment module for all other FCS institutions. Instead, OCFO calculates assessments using resource projections from OSMO. Projections include planned staff hours and travel costs. Based on OSMO’s projections, OCFO provides assessment calculations to the OSMO Director for approval. OCFO then finalizes and communicates the assessments to FAMC.

For the assessment calculation, OCFO uses an estimated blended rate in combination with staff projections of needed staff hours. Although this process is not documented, OCFO stated this blended rate is calculated from the prior year’s actual charges, including overhead and administrative charges, which are then divided into hourly rates based on staff hours. As an example, if in the prior year there were 1,000 staff hours devoted to OSMO at a cost of $100,000 for direct costs and $50,000 for indirect hours, the total hourly rate charged to FAMC would be $150. The Agency would then add overhead and administrative items to the hourly rate to arrive at the total estimated blended rate for the assessment calculation. The Agency maintains a spreadsheet with assessment data from the financial management system. The OSMO Director approves the overall assessment calculation.

When we reviewed the signed, approved copy of the assessment calculations from the OSMO Director for prior assessments, we identified that the shared administrative specialist’s total hours, which included an estimate of the projected hours that the specialist would work for the Office of Equal Employment Opportunity and Inclusion, were included in FAMC’s original assessment calculations. The information provided by OCFO that such hours had been removed was inconsistent with the signed version from the OSMO Director. OCFO personnel stated the assessment calculation was revised, but that they erred in not having the Director sign the revised version. The revised calculation showed the overall hours reduced, but the hourly blended rate increased, resulting in the same overall assessment to FAMC. Because this process is not fully documented, it is difficult to follow how the OCFO arrived at the blended rate and assessment calculations.

In addition, we found that quarterly cost assessments, which include overhead and administrative charges to FAMC, are maintained by OCFO and are not always provided to the Director of OSMO. Throughout the year, OCFO prepares quarterly cost assessments to track actual costs at the Agency by project codes, including FAMC costs. At year end, OCFO reconciles actual costs with these quarterly cost assessments for FAMC. OCFO personnel stated that they send some information to OSMO staff during the assessment and budgeting process. However, the OSMO Director is not receiving the more detailed, quarterly information. We also found that

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1 The assessment module for all other FCS institutions is based on FCA regulations at 12 C.F.R. Part 607 for the assessment and apportionment of administrative expenses.
FCA had not fully documented its methodology for calculating FAMC assessments and costs. OCFO Standard Operating Procedures included the following steps for assessing FAMC:

- Obtain estimated hours and travel costs from OSMO for the upcoming FY examination;
- Exclude estimated FAMC costs to calculate total assessments for the System;
- Notify FAMC of assessment amount;
- Calculate actual exam costs for the year;
- Reconcile estimated assessments with actual exam costs; and
- Adjust the subsequent year’s assessment up or down based on the difference.

The OCFO procedures did not address specific details of OCFO’s methodology and process, especially how it calculates the overhead and administrative costs. The methodology also did not address how OSMO assessments, whether overall projections or actual costs, account for the shared administrative specialist. During our review, OCFO provided a copy of assessment procedures with more details of the assessment calculation for FAMC. In response to our report, OCFO adopted updated assessment procedures and revised the cost policy statements.

**Reporting Relationship**

As part of our audit, we also reviewed OSMO’s reporting process. Section 8.11(a)(3)(C) of the Act stipulates that the OSMO Director “shall be selected by, and report to, the Farm Credit Administration Board.” The Agency’s current organizational structure has the OSMO Director reporting to the Board Chairman and Chief Executive Officer for administrative purposes and to the FCA Board for policy.

However, we found that though the FCA organizational chart shows the OSMO Director reporting directly to the Board Chairman, the reporting relationship has changed over the last few years.

- In 2012, the OSMO Director’s performance evaluation rating official (rater) and reviewing official (reviewer) was the Chairman of the Board.
- Over the next four years, from 2013 to 2016, the Chief Operating Officer (COO) became the OSMO Director’s rater with the Board Chair as the reviewer.
- In 2017, the OSMO Director’s performance plan and mid-year evaluation were completed by the COO as they had been since 2013, but the final rater and reviewer was the Chairman of the Board.
- As of 11/30/17, the COO remained the supervisor of record in the Agency’s personnel system and supervisory database for the OSMO Director.
The OSMO Director stated a previous Board Chair had changed the reporting relationship and the subsequent Chair kept the same reporting structure. However, the current Board Chairman elected to change the structure.

The legal opinions we reviewed by the Agency’s OGC on the establishment of OSMO opined on the reporting relationship of the OSMO Director only in context of what is stated in the Act. We also did not find any official record in current FCA regulations, delegations or designations documenting the reporting relationship or supervision of the OSMO Director to outside the FCA Board.

In a legal opinion from 1992, FCA’s OGC opined that OSMO must act under the control and guidance of the FCA Board. The opinion stated that, in accordance with the Act, the OSMO Director reports to the FCA Board, but it appeared nothing would prevent the Board from delegating its reportee function to a board committee, a board member, or the Chief Executive Officer (CEO). The four options presented made no mention of delegating the reporting relationship outside of a Board Member, the Chairman and CEO, or FCA Board.

Hence, the OSMO Director’s reporting relationship should comply with the Act and Agency legal interpretation. Given the nature of FCA organizational structure, there is constant change within the Board leadership. Documenting the Agency’s position on the OSMO Director independence and reporting relationship will increase transparency and ensure that the FCA Board has considered and accepted potential political and practical concerns associated with any reporting changes.

**Factors Contributing to OSMO Staffing and Reporting**

OSMO utilizes staff from other offices to maintain flexibility. By not hiring additional full-time staff, OSMO can utilize different examiners and other Agency staff, benefit from their different perspectives, and adjust personnel levels based on resource needs. OSMO can also utilize specialized staff for unique needs to meet its mission, and bring them in only when the activities necessitate specialization, allowing for budgetary and staffing efficiencies.

However, this structure necessitates increased due diligence. Documenting and mitigating the risks of this staffing approach will ensure that OSMO and the FCA Board have properly considered that the benefits outweigh the risks. Further, documenting consideration of staff’s potential or perceived conflicts of interest or biases increases transparency and helps to ensure that shared staff will be impartial when considering FAMC issues. Although OSMO Directive 3, *Examiner Ethics*, covers examiner ethics and confidentiality, it can be improved by including the specific risks of conflicts of interest or bias from using examiners and other staff that also work on examination, regulatory, and supervisory matters involving FCS banks and associations.
The assessment methodology described in FCA regulation 607.3, Assessment of banks, associations, and designated other System entities, does not apply to FAMC. Instead, OCFO developed a unique process and methodology for determining FAMC assessments and actual costs. Because FAMC’s assessment calculation is unique, documentation of the process is particularly important. In addition, because OCFO has primary responsibility for calculating assessments and tracking costs, the OSMO Director should receive quarterly cost assessments as an additional internal control to ensure that the process is accurate, fair, and transparent.

Although the OSMO Director holds monthly meetings with the FCA Board Chairman, the supervisor of record for the position in the personnel system is the COO. The personnel system did not include a record of when this supervisory relationship was implemented. Based on FCA legal opinions, the Agency has discretion to delegate certain OSMO oversight responsibilities, as long as such oversight remains within the FCA Board. However, the reporting relationship should be properly documented, justified, and reflected in the Agency’s human resource records to ensure it complies with the requirements and intent of the Act and Agency legal interpretation.

Agreed-Upon Actions 1-5

To improve OSMO’s processes and increase transparency, OSMO agreed to:

1. Revise OSMO Office Directive 3 to include the risks of specific conflicts of interest or bias from using examiners and other staff that also review, or provide services relating to, FCS associations and banks.

2. Require independence documentation from rotational staff to mitigate the risks of conflicts of interest or impartiality concerns.

3. Create an office directive on the assessment process roles and responsibilities.

OCFO agreed to:

4. Document the methodology and process used to calculate the FAMC assessments to include:
   a. details on how the Agency arrives at direct, indirect, overhead, and blended rates.
   b. communicating quarterly reports showing charges against annual FAMC assessments to the OSMO Director for review and confirmation.
   c. a method to clearly separate the costs of shared OSMO employees also performing FCA work from the assessments to FAMC.
The Office of the Board agreed to:

5. Document the reporting relationship between the OSMO Director and the FCA Board including delegations, supervisory relationships, and FCA Board oversight involvement of the OSMO Director.

In response to our report, OSMO revised Office Directive 3 and developed a conflict of interest questionnaire for examiners participating on FAMC activities. OSMO also included a statement addressing conflict of interest and impartiality concerns in rotational assignment agreements. Lastly, OSMO created a directive on FAMC assessment procedures. Based on the completed actions, we consider Agreed-Upon Actions 1-3 resolved and closed.

OCFO provided updated and adopted assessment procedures in response to Agreed-Upon Action 4. OCFO also revised the cost policy statements in response to our report. Therefore, we consider the action resolved and closed.

For Agreed-Upon Action 5, the Office of the Board agreed with the recommendation and is working on a decision on how best to implement. This action remains open.
The objective of this audit was to assess the staffing arrangements and reporting process for OSMO. We conducted the audit at FCA’s Headquarters in McLean, VA from May 2017 through March 2018. We limited our scope to staffing processes and the reporting relationship between the FCA Board and the OSMO Director.

We took the following steps to accomplish the objective:

- Identified and reviewed applicable Federal laws and regulations related to the audit objective.
- Reviewed FCA legal opinions relating to OSMO.
- Reviewed other audits related to the audit objective for background purposes.
- Conducted interviews with the OSMO Director, OSMO staff, OCFO staff, and OAS staff.
- Identified and reviewed applicable internal FCA policies and procedures and office directives.
- Assessed internal control structure in OSMO within the context of the objective.
- Requested and analyzed FAMC assessment process. Reviewed OCFO and OAS data on staffing hours devoted to activities related to FAMC.
- Reviewed staffing structure and compared the structure to requirements in the Act.
- Reviewed OSMO’s reporting processes and relationships within FCA and compared reporting to requirements set forth in the Act.

This audit was performed in accordance with the Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We assessed internal controls and compliance with laws and regulations to the extent necessary to satisfy the objective. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. We assessed the computer-processed data relevant to our audit objective and determined that the data was sufficiently reliable. We assessed the risk of fraud related to our audit objectives while evaluating audit evidence. Overall, we believe the evidence obtained provides a reasonable basis for our conclusions based on our audit objective.