

INFORMATIONAL MEMORANDUM



July 22, 2014

To: Chairman, Board of Directors
All Farm Credit System Institutions

Chief Executive Officer
All Farm Credit System Institutions

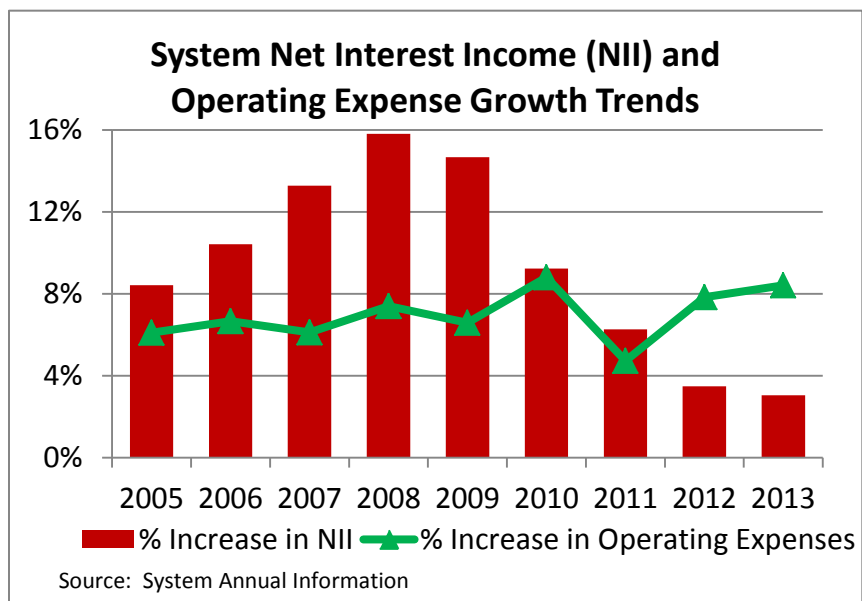
From: Samuel R. Coleman, Director and Chief Examiner
Office of Examination

Subject: Farm Credit System Operating Expenses

Managing operating expenses is a key component of earnings management and ensuring the overall safe and sound performance of a financial institution. As discussed in *The Director's Role* handbook, well-controlled expenses are a fundamental institution strength that contributes to quality earnings.

The Office of Examination has observed a trend in Farm Credit System (System) operating expenses that we plan to evaluate further during examinations. Growth in expenses has been substantial for many institutions. For example, during 2013, expenses increased over 10 percent at 45 associations and over 15 percent at 16 associations. Growth in expenses is

typically not a concern as long as it does not exceed sustainable revenue growth. However, as shown in the adjacent graph, the rate of growth in operating expenses has significantly outpaced growth in net interest income during the past two years. Operating expense levels are not currently a widespread problem, but a continuation of these trends could have a significant adverse impact



on earnings and profitability measures at both the institution and System level.

We recognize that the substantial increase in expenses at some institutions does not necessarily indicate inadequate cost governance. For example, some catch-up in operating expenses is expected in response to the substantial growth in loan volume that occurred a few years ago. In addition, some institutions are strategically increasing staffing levels in advance of expected retirements or are developing financially related services, and are projecting improved efficiencies over the longer term.

You should ensure that your board and management maintain a strong corporate culture in effectively managing expenses. The culture should be evidenced in the institution's:

- strategic planning
- processes for tracking and controlling expenses by business line
- actions to eliminate unnecessary costs
- standardization, automation, or optimization of business processes
- board reporting

We also want to emphasize the importance of addressing operating expenses in your business plan and establishing effective strategies that maintain or improve long-term efficiency and productivity. While expense control is an essential aspect of cost governance, it should be balanced with adequate investment in internal controls, staffing, technology, mission fulfillment, and other organizational needs.

Our future examinations will include a closer look at cost governance. We will examine the causes for increased operating expenses, as well as the processes for managing and controlling expenses. We will also evaluate the strategies for maintaining and improving efficiency, while continuing to adequately invest in internal controls and other organizational needs.

Please direct questions about this Informational Memorandum to your Examiner-In-Charge or Curtis Bednarz, Capital Market Specialist Program Manager, Office of Examination, at (469) 359-4110 or bednarzc@fca.gov.