Farm Credit Administration

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INFORMATIONAL MEMORANDUM

September 9, 2014

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

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

Samuel R. Coleman

Subject: National Oversight Plan for Fiscal Year 2015

The Office of Examination (OE) establishes a National Oversight Plan (NOP) as part of our annual planning processes. Through the NOP, we identify risk topics that we will emphasize in our ongoing examination and oversight activities. This Informational Memorandum provides perspective on our concerns and priorities so they can be considered in your risk assessment and business planning processes. I hope you find this information beneficial in your planning processes.

NOP Risk Topics

OE identified four NOP risk topics for 2015. They include: *Portfolio Management in Volatile Times; Allowance for Loan Loss in Volatile Times; Large, Complex, and Shared Assets; and Board Governance and Nominating Committees*. These topics are further explained below:

- **Portfolio Management in Volatile Times** – Volatile agricultural conditions persist and have actually intensified in the past 2 years. We all recognize agriculture is prone to significant volatility. However, this volatility has changed many of the underlying economic conditions that contribute to "higher highs and lower lows" in many System-financed commodities. Grain prices are trending lower with corn prices already below break-even in parts of the U.S. while livestock, poultry, and dairy prices are increasing. The ethanol industry is also benefiting from lower corn prices with renewed profitability and strong cash flows.

  Volatility is also arising from ongoing drought in the southern plains and California, anticipated interest rate increases, and reduced government support programs. These conditions, individually and collectively, erode borrower repayment capacity, liquidity, and ultimately solvency and collateral values. The potential impact may become more visible during producers' 2015/16 financial reviews and credit renewals. We expect these conditions will especially challenge borrowers that invested in higher-priced land (or rental contracts) and equipment over the past several years. Proactive and diligent portfolio management is particularly important to this volatility, potential for reduced profitability, and increased borrower stress over the next several years. This will require close attention from both FCS institutions and FCA examiners. The System and most of its borrowers are well-positioned to manage this volatility. I strongly encourage you to assess whether your institution's risk management practices or board of directors (board) oversight need fine-tuning to preserve this condition. We will be focusing on the adequacy of institution efforts to ensure proactive and disciplined loan underwriting and servicing in a continued volatile environment.

- **Allowance for Loan Loss in Volatile Times** – The System's allowance for loan loss coverage has declined significantly in recent years. As of June 30, 2014, the combined allowance for loan loss was $1.2 billion (or 0.57 percent of assets). While not directly comparable, commercial banks maintained an industry-wide 1.72 percent allowance level at yearend 2013. Many institutions have reversed allowances in recent periods, which may be inconsistent with changing and more volatile agricultural conditions. In the current environment, the boards and management should be increasingly conservative and ensure allowances appropriately reflect the credit and collateral risks embedded in the institutions' financial statements. The System's external auditor will require detailed analysis and documentation to support allowance levels. This analysis should reflect prudent judgment based on your experience and industry knowledge. We will maintain an ongoing dialogue with the external auditor on our allowance-related expectations.

- **Large, Complex, and Shared Assets** – The System is increasingly involved in large, complex, and shared assets. We increased our examination of these assets in recent years and will continue this focus in 2015. These assets (currently defined as lending relationships exceeding $20 million in commitments held by two or more institutions) total $88 billion. They are widely participated throughout the System to achieve various institutional objectives including portfolio diversification and business plan goals. Some institutions have become increasingly reliant on participations to offset reduced market demand from within their chartered territories. We plan to evaluate loan conditions, covenants, and other credit and portfolio controls on these assets to determine if risks are managed properly.

- **Board Governance and Nominating Committees** – The quality of a board and its operations is paramount to an institution and the System's success. I believe strongly that each board can benefit from conducting insightful self-evaluations and third-party evaluations, utilizing board consultants, employing an effective committee structure, and conducting ongoing director training programs. Likewise, a board must have high-quality director talent that is sourced from a Nominating Committee process that effectively identifies and vets director candidates. We plan to evaluate the institution board operations and director training programs, as well as Nominating Committee effectiveness.

While not addressed specifically in this memorandum, we will also maintain a risk-based examination focus on other topics such as standards of conduct and the new Consumer Financial Protection Board Regulations.

Please use this information to understand our priorities for the upcoming year. This memorandum should be distributed to your fellow board members and discussed with the Audit Committee chairman, other board committees, and your executive management team. Please contact your designated examiner-in-charge or me at (703) 883-4246 (colemanr@fca.gov) if you have any questions.

Copy to:

Chief Executive Officer, All Farm Credit System Institutions
Chief Executive Officer, Farm Credit Council
Chief Executive Officer, Farm Credit Council Services
Chief Executive Officer, Federal Agricultural Mortgage Corporation