Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

INFORMATIONAL MEMORANDUM

September 24, 2015

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

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

Subject: National Oversight Plan for Fiscal Year 2016

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 two NOP risk topics for 2016. They include: *Internal Controls and Operations Risks* and *Intensifying Credit Risk*. These topics are explained below:

Internal Controls and Operations Risks – OE intensified its internal controls and operations risk assessments significantly in 2015, and this effort will continue into fiscal year 2016. We have found instances where certain institutions may not have all of the necessary internal controls to ensure their enterprise risks are managed sufficiently. Despite an institution's size or complexity, the Farm Credit Administration (FCA) expects all institutions to have an effective control environment over its operations, including a highly effective internal audit program. Each board should ensure sufficient resources are invested in the institution's internal control environment to maintain effective preventive and detective controls that mitigate risk and prompt any needed corrective actions. This internal control environment must be consistent with requirements established in FCA Regulation 618.8430.

In a few instances, the Farm Credit System (System) has experienced control weaknesses that have led to financial losses. As you know, any one association lacking necessary internal controls can cause not only a significant loss to that association, but also create reputation risk for the System. As a result, we intensified our internal controls examination program for all institutions. We refreshed our examination programs and developed several new work programs including:

- Delegated Lending Authority and Loan Committee;
- Internal Audit;
- Chattel Collateral Verification;
- Loan Origination, Disbursements, & Payments; and,
- Whistleblower Programs.

These programs were implemented earlier this year and we plan to continue an internal controls assessment as part of each examination in fiscal year 2016. Our examiners will be discussing our expectations for an institution's internal controls, as well as specific findings related to your internal control environment. We will evaluate all related examination findings for System institutions and communicate the general themes to the System at a future date.

Finally, we issued an Informational Memorandum entitled *Whistleblower Programs* (July 9, 2015) to communicate regulatory expectations. Please review this memorandum closely and ensure your institution has an effective whistleblower program that is understood throughout your institution. This is one of many internal control techniques that can alert the board to a potential risk at the earliest opportunity, and possibly while losses or damages can be prevented or at least minimized.

We will also highlight cybersecurity as part of our internal controls assessment. This is being pursued aggressively given the persistent security incidents occurring outside the System. Our focus is also supported by certain security-related weaknesses identified in some of our System institutions' information technology examinations. This is another critical area requiring specialized resources for your internal controls environment and diligent audit committee oversight.

Intensifying Credit Risk – Credit and collateral risk conditions are intensifying in several areas. We have discussed volatile conditions in several past Informational Memorandums communicating our NOP. For some institutions, these conditions are now presenting the risk environment that both FCA and many of you were anticipating. Some of the most significant conditions affecting your operating environment include:

- Declining commodity prices and margins – especially corn and soybeans;
- Ongoing and severe drought in California and the western United States; and,
- Increasing value of the U.S. dollar and the effect on agricultural trade.

After several years of record farm income, deteriorating commodity prices for certain grains are causing the potential for increased credit and collateral risk. Some System borrowers expanded significantly via higher-cost real estate that was either purchased or rented, increased capital expenditures for equipment, and increased family living expenses. As the 2015 crop was planted, producers, especially corn and soybean growers, realized that they might generate net losses. Real estate rents and the cost of crop inputs (e.g., seed, fertilizers, and chemicals) remained "sticky" and generally did not decline. Some of our mid-2015 credit examination activities identified some borrowers that exhausted their working capital due to significant operating losses, and this has, to varying degrees, compromised the operational stability of their farming operations. This condition is expected to continue to be most prevalent in corn and soybean operations – especially in the Midwest. Agricultural experts predict many corn and soybean operations will operate near breakeven levels for possibly several years. During this period, some farm operations will risk eroding working capital. These experts also warn that the most vulnerable operations will include younger farmers, with lower working capital levels and equity, which depend substantially on rented land.

The System's financial condition remains strong and it is thought to be capable of working through these changed risk conditions with its borrowers. However, boards should ensure the institution's credit functions are proactive and responsive. This may require credit staff to counsel customers, restructure debts, and establish stronger credit controls. In the more severe cases, the System may need to update its ability to handle this increased credit risk through special credit departments and ensure all FCA Borrower Rights requirements are administered properly. The Office of Examination issued an Informational Memorandum entitled *Portfolio Management in Volatile Times* (January 29, 2015). This memorandum emphasized the risk conditions and encouraged the System to ready itself and its customers for less favorable conditions. We are planning additional communications with you in the next several months as we continue updating portions of our credit-related examination guidance.

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 chair, 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.