Farm Credit Administration
Informational Memorandum

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May 9, 2008

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit Banks and Associations

From: Thomas G. McKenzie, Director and Chief Examiner
Office of Examination

Subject: Asset Growth, Market Volatility, and Best Practices for Fast Growing Institutions

The purpose of this Informational Memorandum is to continue our communications regarding Farm Credit System (System or FCS) growth and emerging risks in agriculture. We also provide "Best Practices" we have observed for institutions experiencing rapid growth.

The System continued to grow rapidly in the first quarter of 2008 because of high commodity prices, input costs, and farmland values. System assets reached $197 billion at March 31, 2008, up nearly 6 percent from three months earlier at yearend 2007. This follows three years of double-digit growth. In 2007, System assets increased 14.5 percent from the previous yearend and was the second fastest rate of growth in more than 20 years, second only to 2006. Loan volume grew 15.8 percent in 2007, and more than half of FCS institutions grew by double digits last year. Current conditions in the farm economy point to continued strong demand for agricultural credit and more asset growth for the FCS.

We want to emphasize that the Farm Credit Administration (FCA) regards growth in a positive light and recognizes that growth of the business supports mission accomplishment and a healthy institution. That is, growth is positive as long as it is well planned and managed, focused on mission, and kept within an institution's managerial and financial capabilities.

The continued high rate of growth in the System calls for increased vigilance, particularly in view of the current market volatility, the prices of many agricultural commodities, the costs of key production inputs, and significant increases in agricultural real estate prices.

We continue to challenge boards of affected institutions to maintain close assessment of the current situation. Boards should manage this unprecedented growth through diligent planning, and strengthened risk management processes, internal controls, and reporting systems[1]. Doing so will allow boards to maintain strong oversight of asset growth, the changing environment, and the effects on their institutions.

[1] This was also emphasized in our Informational Memoranda (IM) dated February 9, 2007 and November 21, 2007. We urge you to review these earlier memoranda as you consider the Best Practices provided in the Addendum to this IM.

As part of the Office of Examination's (OE) oversight of the System, we recently completed the first phase of a National Examination Activity (NEA) that considered the systemic risk associated with asset growth. To effectively mitigate the risks associated with rapid growth, FCA's oversight activities found that successful boards focus on assuring that:

- Information systems and reporting processes timely identify potential risk profile changes and promote effective supervision of the organization;
- Internal control, audit and credit review programs timely verify accuracy of information and reliability of risk management systems;
- Underwriting practices are closely monitored and adjusted when appropriate to assure they remain sound;
- Compensation programs do not unduly focus on growth;
- Planning processes provide a reasonable forecast and basis for decision-making; and,
- Counterparty risks are fully understood and addressed.

The best practices addressed in the Addendum touch on all of these topics and are consistent with our expectations for effective risk management practices.

As part of the second phase of the asset growth NEA, we are conducting the examination program identified in our November 2007 Informational Memorandum at select FCS institutions. We plan to take a close look at these institutions to verify that they have the financial capacity as well as the management systems, controls, and risk management processes commensurate with the changes occurring in their institutions. You may also expect examiners to focus on and test internal review programs and the internal control environment in most institutions in the coming months. As you know, your review and internal audit programs are of particular importance as they are critical to the timely identification of risk and in recommending risk mitigation strategies needed for your institution.

The uncertainties of the current environment underlie the importance of effective "Best Practices"[2] in managing System growth. Record high commodity prices have spurred rapidly increasing farmland values and strong loan demand in much of the central part of the United States. However, increased feed and energy costs have created stress for much of the livestock industry, and problems in the housing sector have impacted other sectors of agriculture in many parts of the nation. The extreme volatility in commodity prices is expected to continue. The prospect of substantial increases in production expenses and asset values also contribute to the uncertainties in the current environment.

In many ways agriculture is navigating uncharted waters. Energy prices and Government policies are important factors in shaping current operating conditions in agriculture; however, these factors can change quickly. Conditions also may be affected by a global response to today's high commodity prices, bringing more acreage into production. Such a supply response could lead to lower commodity prices and farmland values at a time when production expenses are high and slower to adjust as crop prices decline. As you know, these concerns have been addressed by many experts and reported in the media and various industry publications. We

[2] Please refer to FCA Examination Bulletin, FCA 2007-1, *Communicating Examination Expectations*, which provides guidance on the application of "best practices."
http://www.fca.gov/examman.nsf/82e009ce4f225208852571a20068efb8/f50ca67efc5c92a985257363004590bd?OpenDocument

provide just a few articles through the links below for your review and discussion as you consider the changing risk environment. [3]

Given the rapidly changing, volatile and uncertain environment, now is the time for the System and FCA to proactively address the potential systemic risk of rapid growth to agricultural lenders. We urge the FCS to adopt the Best Practices in the Addendum as appropriate for your institution. As the Farm Credit System's safety and soundness regulator, you can expect our examiners' oversight and examination activities to intensify on asset growth and credit risks, as well as on the actions that boards and management are taking. A critical part of our plan is to have periodic discussions on credit topics with leaders in the Farm Credit System to make sure that we understand the opportunities and challenges of the marketplace. As an example of these sessions, a forum with the Chief Credit Officers of the banks is scheduled in mid-May to discuss their outlook, as well as, some of these challenges.

If you have any questions about this Informational Memorandum, please contact Roger Paulsen, at (703) 883-4265, or at paulsenr@fca.gov, the examiner-in-charge assigned to your institution, or me at mckenziet@FCA.gov.

Copy to:
Federal Farm Credit Banks Funding Corporation
Farm Credit Council
Farm Credit Council Services

[3] Nancy Jorgensen, "Things You Need to Know about 2008," *Today's Farmer*, Dec 2007/Jan 2008, http://www.mfaincorporated.com/web/guest/todaysfarmer/991001/991010
Daryll Ray, "Five, Ten, Fifteen—Dollars per Bushel, that is," Agricultural Policy Analysis Center, January 11, 2008. http://www.agpolicy.org/weekcol/388.html
Gary Schnitkey, "Are Farmland Prices in Line with Farmland Returns?," *Farm Economics Facts & Opinions*, October 10, 2007. http://www.farmdoc.uiuc.edu/manage/newsletters/fefo07_15/fefo07_15.html
Calum G. Turvey, Professor, Cornell University, *New York Economic Handbook: 2008* http://aem.cornell.edu/outreach/outlook/2008/Chap4Finance2008.pdf
Cole Gustafson, "A Pulse from the Prairie," USDA 84th Agricultural Outlook Forum, February 22, 2008. http://www.usda.gov/oce/forum/2008Speeches/PDFPPT/Gustafson.pdf

Farm Credit Administration **Addendum**
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This addendum provides an outline of "Best Practices" that we found particularly important for fast growing institutions. Boards should discuss with management the appropriateness of these practices to their institution's circumstances.

- **Board Supervision –** Frequent production and review (i.e., quarterly) of reports on asset growth, including its amount, nature, source, and quality were essential to effective supervision. These reports provide an analysis of the effects of growth on the composition, quality, and performance of the portfolio. They explain deviations from business plan assumptions and projections and where variances are significant. These reports also discuss implications to financial condition and performance, as well as to operations. Moreover, these reports pay particular attention to the underwriting or other policy exceptions to determine whether troubling patterns are emerging that signal risk in the portfolio is rising or that questions regarding staffing, internal control sufficiency, or regulatory compliance may be warranted.

- **Internal Controls, Audit and Credit Review** – Fast growing institutions increase the frequency and scope of their control validations; when deficiencies are identified, they analyze and respond to the cause of these weaknesses. For example, we recently encouraged internal reviewers to review all large assets within 90 days of origination for compliance with underwriting standards and to verify risk ratings. Maintaining controls commensurate with an institution's growth and changing complexity are particularly important, and a periodic evaluation is performed of internal controls as well as audit and review programs. Credit reviewers, internal auditors and appraisers are excellent sources of information for boards and management to use in assessing underlying systemic risks that are emerging in an institution's portfolio. The additional insights gained from these sources can help institutions assess and revise underwriting and loan structuring, as may be needed for the current lending environment.

- **Underwriting and Loan Structuring**– Sound loan underwriting practices were critical, especially given revenue volatility facing producers, rising production expenses, and the uncertain prospects for net income. While favorable conditions currently exist for many producers and agribusinesses that benefit from these conditions, prudent institutions recognize the prospect for price volatility in both agricultural products and operating costs, and consider the possible effect on cash flows in structuring loan repayment terms and debt service requirements. Accordingly, these lenders support lending decisions while considering both historic cash flow projections and management performance, and the present day long-term industry outlook. This was particularly important in real estate lending. Since reduced profits would likely result in a trend reversal for increasing real estate values, lenders do not unduly weigh the current value of assets serving as collateral in their decision process. The best managed institutions intensified their lending controls and collateral risk management practices during these times, giving consideration to adjusting loan structures, collateral underwriting practices, repayment terms, or loan conditions that allow them to respond to and mitigate risk when events warrant.

- **Compensation Programs** – Compensation programs, particularly those with incentive or bonus features, are structured in a manner that balances maintaining sound assets and effective internal controls with any financial incentives used to promote asset growth, operating efficiency or increased earnings.

- **Business Planning Processes** – Business planning processes and the resulting business plan thoroughly address asset growth—including reasonable growth projections. In addition to discussing regulatory requirements, business plans and their supporting documents analyze and discuss the following:

  - Projected growth, including information on the past sources of growth, an analysis to support projections, and strategies for achieving growth goals. Projections should include two or more alternative scenarios regarding asset growth.

  - Portfolio management tools employed to manage the growth effects on portfolio composition, diversification, quality, and profitability, and capital ratios.

  - Assets sold, but serviced (off-balance sheet), including a discussion of the risk associated with these assets (e.g., compliance with representations and warranties) and how selling these assets fits into the institution's business model.

  - Operational risks and the capacity of the institution to balance asset growth with effective risk management processes and sufficient financial capacity. This is particularly important for fast growing institutions or those engaging in new markets or products.

  - Staffing and skills required to grow lending in any new products or markets, including a more measured implementation approach when these resources were not readily available.

- **Counterparty Due Diligence** – Due diligence processes that ensure an independent, fully informed credit decision on assets originated by a third party were paramount. Counterparty relationships can be a source of several types of risk, including credit, financial, operational, and reputation risk, so effective processes to understand and assess the risks emanating from this third party relationship are also in place. Boards of directors monitor counterparty exposures carefully, particularly when rapid growth in asset purchases and capital markets transactions occur.