Farm Credit Administration

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INFORMATIONAL MEMORANDUM

September 27, 2016

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 2017

The Office of Examination (OE) establishes a National Oversight Plan (NOP) as part of our annual planning process. Through the NOP, we identify risk topics that we will emphasize in our ongoing examination and oversight activities. This Informational Memorandum (IM) provides perspective on our priorities so they can be considered in your risk assessment and business planning processes. It also highlights OE's expectations concerning your internal controls environment.

NOP Risk Topics

OE has identified two NOP risk topics for 2017. They include: *Intensifying Credit Risk – Deeper into the Commodities Cycle* and *Implementing the New Capital Regulations*. These topics are explained below:

Intensifying Credit Risk – Deeper into the Commodities Cycle – Previous NOP and credit-related communications highlighted that credit and collateral risk conditions have been intensifying over the past several years. These communications encouraged Farm Credit System (System) institutions to be cautious given the potentially volatile conditions. The cycle for certain commodities peaked in 2013 with record prices and net farm income. Since then, many of those commodity prices have fallen while corresponding input and real estate prices changed little. The declining commodities cycle continues with many producers projecting losses or limited profits in 2016/17. In addition, dealer and auction results report some agricultural equipment values are declining and the Federal Reserve Board reports real estate values are softening in regions where the stressed commodities are produced. This will further affect many borrowers' solvency and loan collateral values.

These credit risk conditions are spreading across many agricultural commodities, including the grains, fiber, dairy, and protein sectors. These commodities comprise a significant portion of the System's loan portfolio. Absent a serious production event or unexpected demand shock causing a price rally, more producers are likely to experience some financial stress and repayment capacity problems. These conditions may likely become more apparent during the 2017 credit renewal season if weak commodity prices persist and producers report further declines in cash flow, working capital, and solvency. We are already seeing some of these conditions in loan examination activities. However, we realize many borrowers are working from a position of financial strength and can adjust operations in response to lower commodity prices.

System institutions will need to be proactive as they address the changed risk conditions with customers. Paramount to effectively managing these conditions is the timely and accurate identification of loan risk by the institution. Once identified, constructive actions are required by both the institution and the customer. It is critically important to address these loan and portfolio issues proactively so risk can be managed effectively. Some customers may require closer account monitoring or counseling. Others may require balance sheet restructuring or more substantive financial restructuring. Accordingly, each System institution must have the needed credit resources to manage loans requiring more active servicing. You should re-evaluate your staffing to ensure there are adequate special credit resources to manage the changed risk profile constructively – for both the borrower and the institution. We issued IMs entitled *Portfolio Management in Volatile Times* (January 29, 2015) and *Servicing Loans to Borrowers in Distressed Industries* (January 21, 2016). This guidance emphasized the risk conditions and encouraged System institutions to ready themselves and their customers for less favorable conditions.

The changing credit conditions are expected to result in an increased need to afford FCA Borrower Rights on distressed loans. As referenced in the *Servicing Loans to Borrowers in Distressed Industries* Informational Memorandum, "…most Farm Credit System (System) institutions have the financial capacity and risk-bearing ability to work with borrowers experiencing stress. We expect System institutions will use this capacity to work with borrowers as they navigate through a potentially stressful period." We are planning additional credit-related communications with you as we continue updating our guidance.

Implementing the New Capital Regulations – FCA adopted a final rule establishing new capital regulations that will become effective January 1, 2017. The regulations modernize the capital requirements and ensure institutions will hold enough capital to fulfill their mission as a Government-sponsored enterprise. It also updates the System's capital requirements to make them comparable with the Basel III framework, regulations of other Federal banking agencies, and to meet the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*. These regulations prescribe Tier 1 and Tier 2 capital ratio requirements and update the risk weightings on each asset class. FCA is also in process of updating its Call Report schedules to provide for increased capital-related reporting.

We will assess strategies and internal controls that promote accurate capital reporting and compliance with the new capital regulations. Each board should ensure it develops an understanding of the impact of these regulations on its institution and has a clearly defined plan to ensure compliance. This plan should include developing policy and procedural direction, ensuring independent and timely validation and audit of capital ratio calculations, and applying critical model risk governance principles to the capital ratio measurement model. We will examine the internal controls you rely upon in this process. We will also share our expectations for effective implementation of the regulations in a separate communication.

Continuing Focus on Internal Controls

An effective internal controls environment is paramount given the changing conditions addressed in this memorandum. As communicated previously, we expect each institution, regardless of its size or complexity, to have an effective internal control environment. The most significant controls include board oversight, up-to-date policies and procedures, risk parameters, and internal audit coverage. Each board should reassess these control elements and ensure that an effective control environment exists throughout the institution. In particular, the board should re-evaluate Audit Committee oversight, the internal audit plan and risk assessment, and internal audit resources. Ensuring adequate internal audit coverage will be critical to help the board evaluate the institution's changing risk profile and manage the institution.

Please use information in this IM to understand our priorities and expectations for the upcoming year. It should be distributed to and discussed with your institution's board members and executive management team. Please contact your designated examiner-in-charge or me at (703) 883-4246 (colemanr@fca.gov) if you have any questions.