Farm Credit Administration

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INFORMATIONAL MEMORANDUM

October 3, 2022

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

From: Mike Duffy, Director and Chief Examiner
Office of Examination

Subject: National Oversight Plan for Fiscal Year 2023

The Farm Credit Administration's Office of Examination annually establishes a National Oversight Plan (NOP) as part of our planning process. Through the NOP, we identify focus areas we will emphasize when examining and overseeing Farm Credit System (System) institutions during the next fiscal year. We issue this informational memorandum each year to notify institutions about our priorities. You will notice recurring themes from previous NOPs, which reflect the continuing importance of these areas.

The focus areas for fiscal year 2023 are as follows:

- Risk management practices in an uncertain environment
- Phaseout of the London Interbank Offered Rate (LIBOR)
- Current expected credit losses (CECL) implementation
- Young, beginning, and small (YBS) farmer and rancher programs
- Standards of conduct
- Small, low-risk associations

We discuss these areas in more detail below. I hope you find this information beneficial.

Risk management practices in an uncertain environment

The current business environment is exposed to a great deal of uncertainty. This includes macroeconomic headwinds and a rapidly changing information technology (IT) operations landscape. While the future is unknown, we recognize the System is well positioned to meet these challenges. The System's overall financial position is sound, with strong capital, earnings, and liquidity. In addition, asset quality is excellent compared to historic norms. We will consider your individual institution's financial strength and asset quality as we establish risk-based scopes of examination.

Macroeconomic headwinds

As 2022 unfolds, economic growth has slowed considerably amid surging inflation and rising interest rates. Globally, Russia’s invasion of Ukraine and the subsequent war introduced additional uncertainty into the supply chain and already volatile energy and commodity markets.

Like the general economy, the farm economy faces challenging market conditions. Commodity prices have generally remained high, but margins have declined because of increasing costs of crop inputs, energy, land, transportation, and labor, as well as feed for livestock and dairy producers. Drought in the western United States continues to affect both crop and livestock sectors. Also, while government payments have bolstered farm income in recent years, it is uncertain whether additional government support will be made available if margins erode to unprofitable levels.

Our examination program will emphasize 2023 strategic business plans, focusing on the adequacy of capital and portfolio planning. Our examiners will review your institution’s plan to make sure you assessed key uncertainties in the operating environment when you evaluated your capital needs and set capitalization goals and strategies.

Similarly, we will evaluate whether your stress-testing scenarios were sufficient to capture the impacts of the macroeconomic headwinds on borrower financial performance and your portfolio quality. We will also review management’s guidance to staff for loan underwriting and credit administration to ensure it adequately addressed these risks.

Rapidly changing IT operations landscape

IT operational risk is elevated as System institutions respond to an evolving and increasingly complex business environment. Cyber risks and threats continue to challenge organizations as the financial sector becomes more digitized and the remote work environment becomes a permanent part of many institutions’ business model. Moreover, increasing investments in new technologies to replace outdated and antiquated legacy financial systems create a continued strain on resources.

Our examination program will continue to explore how your institution is managing risk arising from the evolving IT operations landscape by evaluating the following:

- Vulnerability management programs and practices, including your institution’s periodic review of its systems, processes, and strategies
- Cybersecurity threat assessments and incident response plans to ensure continuity of operations
- Large-scale software development and upgrade projects for critical financial systems

LIBOR phaseout

The administrator of LIBOR previously announced that all remaining U.S. dollar LIBOR settings will cease to be published after June 30, 2023. In previous informational memorandums, we identified action steps and timeframes to guide your LIBOR transition efforts.[1] We will continue to examine the extent to which your institution has adhered to the sound practices described in those informational memorandums. We will focus on evaluating whether your LIBOR phaseout plan and resource commitments are consistent with the level and complexity of your institution's remaining LIBOR exposures.[2]

At institutions with material LIBOR exposures, our examinations will also focus on management's actions to

- assess and remediate fallback provisions,
- ensure operational capacity to handle the potentially high number of fallback rate adjustments,
- conduct due diligence when alternative interest rates are used,[3] and
- ensure that rate change disclosures comply with FCA and consumer lending regulations.[4]

CECL implementation

With the implementation of Accounting Standards Classification (ASC) Topic 326 on January 1, 2023, CECL will replace the incurred loss model for estimating allowance needs. Allowance levels under CECL will continue to incorporate qualitative and quantitative factors in estimating credit losses, but CECL will require you to consider a broader range of economic data, including past events, current conditions, and reasonable and supportable forecasts that affect collectibility.

Our examiners will continue to assess whether your institution is following sound business practices in developing and implementing CECL models. For example, we'll evaluate whether you are developing CECL-related control structures, including internal control over financial reporting. We will also evaluate whether you are developing well-documented processes and routinely validating model output.

YBS programs

Supporting YBS farmers, ranchers, and aquatic producers remains of critical importance for the long-term viability of U.S. agriculture. The Office of Examination will continue to support FCA's strategic goal for YBS by encouraging the System to support YBS producers. In addition, we will continue developing the YBS rating system for institution programs as well

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[1] See the following informational memorandums: December 8, 2021, Managing the LIBOR Transition; October 4, 2021, National Oversight Plan for Fiscal Year 2022; December 18, 2020, LIBOR transition guidance; October 5, 2020, National Oversight Plan for Fiscal Year 2021; and September 11, 2018, Planning for LIBOR Phase-Out.

[2] Sound practices are also described in the July 11, 2022, LIBOR Legacy Playbook published by the Alternative Reference Rate Committee.

[3] See the December 8, 2021, informational memorandum.

[4] For loans with fallback provisions in which you determine the applicable replacement rate, you should provide notice of your institution's planned replacement rate and any related provisions at least six months prior to the earlier of the date that a replacement rate would become effective or June 30, 2023.

as coordinating with the System and other FCA offices to improve the usability and consistency of YBS lending and nonlending data.

Standards of conduct

As previously reported, we amended our regulations governing standards of conduct for the directors and employees of System institutions; the amended regulations become effective January 1, 2023. The final rule requires each System institution to have or develop a standards of conduct program based on core principles; the purpose of the program is to integrate ethical values into corporate culture.

Because of the extent of the changes institutions will be making to their standards of conduct programs, we will conduct a horizontal examination activity to examine the implementation of the new regulations. This activity will include a review of template policy and procedure guidance being used in the System. At a sample of institutions, we will then complete an examination of materiality definitions and thresholds, including support for these determinations. Following the horizontal examination activity, our examiners will continue reviewing standards of conduct programs through routine examinations at all institutions.

Small, low-risk associations

We will continue to support FCA's efforts to explore ways to address the concerns of associations considered low-risk based on size, complexity, financial condition, and governance. We will collaborate with other FCA offices to evaluate and consider various possibilities to enhance risk-based application of examination expectations for smaller institutions with low-risk profiles.

About this guidance

Please use this information about our priorities in your planning for the upcoming year. Also, please distribute this memorandum to your board members and discuss it with your audit committee chair, other board committees, and your executive management team. Your examiner-in-charge will discuss this information with your board in an upcoming videoconference or phone call.

If you have any questions, please contact your designated examiner-in-charge or me at (703) 883-4265 (duffym@fca.gov).