Farm Credit Administration

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INFORMATIONAL MEMORANDUM

September 26, 2024

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

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

Subject: National Oversight Plan for Fiscal Year 2025

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 for the coming fiscal year. We issue this informational memorandum each year to notify institutions about our priorities. I hope you find this information beneficial.

For fiscal year (FY) 2025, you will notice recurring themes from previous NOPs. The recurrence of these themes reflects their continuing importance. The focus areas are as follows:

- Sustainability of capitalization practices
- Innovation through automation and artificial intelligence
- Mission-focused lending
- Sound governance
- Credit and collateral risk exposure
- Cyber risk management

Sustainability of capitalization practices

While the System remains well capitalized, a number of institutions face the longer-term challenge of capitalizing their asset growth. As a result, we will continue to focus on the long-term sustainability of System capitalization practices, with an emphasis on the following processes:

- Evaluating asset growth and the needs of the customer base
- Assessing the impact of profitability, leverage, and capital distributions on the institution's ability to capitalize growth through retained earnings
- Reviewing and recalibrating capital plans and strategies, as necessary

Innovation through automation and artificial intelligence

Innovation through automation and artificial intelligence (AI) has significantly transformed traditional banking and financial services. Automation can improve efficiency and reduce costs by handling repetitive and time-consuming tasks. Advances in computing capacity enable financial institutions to leverage AI for risk management functions, operational purposes, and enhanced products and services for all creditworthy borrowers. We understand why System institutions are pursuing these opportunities and benefits.

As with any new product or service, maintaining sound risk management processes is critical for identifying, reporting, and controlling risks associated with automation and AI. Effective risk management includes due diligence and risk assessment, appropriate staffing, and sound governance and control practices.

We will survey System institutions to better understand which automation techniques you are using, how you are using AI, and, more importantly, how you are managing and governing risks associated with these innovations. To evaluate automation and AI risk management practices, we will use FCA Examination Manual guidance on such topics as Model Risk Management (PDF), Third-Party Risk Management (PDF), and Information Technology & Security (PDF).

Mission-focused lending

FCA continues to stress the importance for the System to promote its public mission. We encourage you to continue to use both lending and nonlending programs to ensure you are serving eligible young, beginning, and small (YBS) farmers and ranchers, as well as underserved groups, in your institution's territory. Various nonlending strategies and lending programs can be implemented to better serve the needs of all creditworthy borrowers.

The System is already required to report YBS lending and nonlending data to FCA. During our business plan examinations, we will review strategies and programs intended to serve YBS and underserved groups in your institution's territory.

Accurately assessing borrower eligibility and scope of lending is critical to ensuring your lending activities support the public mission while remaining consistent with the Farm Credit Act and FCA regulations. We are aware of the urban development pressures on agricultural land around various metropolitan areas. While we always expect institutions to determine eligibility and the scope of lending for any borrower and loan request, we emphasize the importance of completing a detailed and well-supported assessment when lending in these transitional areas. In FY 2025, our examiners will increase their focus on evaluating your institution's eligibility and scope of lending guidance, including criteria and documentation expectations.

Sound governance

Consistent with broader market trends, the System is experiencing or anticipating greater turnover among board members and senior managers. Turnover can present a challenge to your institution's corporate governance, culture, and control environment. As we continue to monitor turnover and the implications for System institutions, we will focus examinations on

areas central to maintaining strong governance and a sound control environment, including but not limited to the areas described below.

Succession planning

Effective succession planning processes are essential to ensuring strong governance and a sound control environment. Succession planning should cover all key positions and should aim to build bench strength across the institution. In recent years, we have seen an increase in mergers, joint management agreements, and System consolidation; while these can lead to positive outcomes, they should not stem from lack of succession planning and development of internal staff.

Director elections

Sound processes and controls for director elections help ensure your board is representative of the stockholder base and has the necessary skill set to fulfill its fiduciary duties. These processes and controls begin with an independent, knowledgeable, and resourceful nominating committee. In addition, impartiality, confidentiality, and security in director elections and voting processes are necessary to ensure stockholder confidence and facilitate sound governance.

Standards of conduct (SOC)

Finally, the board and management's commitment to integrity and ethical behavior is critical to the overall control environment of your institution. Since the new SOC regulations took effect on January 1, 2023, steps were taken to implement the regulations. For example, System institutions revised their SOC guidance, implemented a code of ethics, conducted training, and collected and evaluated disclosures under the new rule. These are vital steps to having sound governance and a strong control environment; however, you must then ensure that you have a culture consistent with your institution's SOC guidance and code of ethics. This work begins at the top with the board and executive management.

Credit and collateral risk exposure

Many System institutions have experienced continued growth in their capital markets portfolios. While capital markets lending helps institutions diversify their loan portfolios and provides other benefits, the risk profile of this segment has increased since 2023. Additionally, some of these loans are highly leveraged, equity sponsored, or covenant lite, and all of these characteristics require greater System expertise. Therefore, consistent with our examination strategies in FY 2024, we will continue to focus on evaluating capital markets portfolios and internal controls, including those related to monitoring and reporting.

While recognizing the cyclical and volatile nature of agriculture, we have emerging concerns regarding the impact of declining farm income and expect a more challenging lending environment. Weaker commodity prices in 2024 and elevated costs, including higher interest rates, created a challenging environment for many producers. Additionally, disease outbreaks, including avian flu, continue to present unique risks and challenges to livestock producers as they deal not only with production losses but also potential market disruptions. Our examinations in FY 2025 will cover more loans to customers with higher risk characteristics to ensure accurate and timely risk identification and proactive loan servicing under these more difficult operating conditions.

Lastly, we emphasize the need for institutions to maintain prudent collateral risk management practices because we see early signs of softening real estate values. Farmers and ranchers remain the primary buyers of agricultural land, but declining profit margins, coupled with high interest rates, are likely to pressure land values. In addition, volatility in the general economy could result in reduced demand for real estate from part-time farmers or investors. As a result, we will continue to focus on evaluating your collateral risk management practices and controls, including loan underwriting controls.

Cyber risk management

The cyber risk management rule becomes effective January 1, 2025, requiring your institution to implement a comprehensive, written cyber risk management program consistent with the size, risk profile, and complexity of your operations. This rule sets forth the core principles that serve as the foundation for creating a comprehensive cyber risk management program and framework.

Such a framework should include a vulnerability management program to monitor cyber threats, mitigate any known vulnerabilities, and establish mechanisms for reporting to your institution's board and FCA. We will complete a horizontal examination activity to evaluate compliance with the new and revised regulations at a sample of System institutions.

About this guidance

Please use this information about our priorities in your planning for the upcoming year. Also, please distribute this memorandum to all board members and discuss it with the audit committee chair, other board committees, and executive management. Our examiners-in-charge will discuss this information with you 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).