Farm Credit Administration

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

INFORMATIONAL MEMORANDUM

September 19, 2017

To: Chair, 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 2018

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.

NOP Risk Topics

OE identified two NOP risk topics for 2018. They include: Portfolio Risk – Weathering the Storm and Internal Controls Over Financial Reporting. These topics are explained below:

Portfolio Risk – Weathering the Storm – Production agriculture has experienced considerable volatility in recent years. Over the last several years net farm income has declined. Low price levels for key commodities have lingered and producers are "weathering the storm" awaiting improved prices. During this period, working capital and the debt repayment capacity cushion eroded for many producers. While we expected more credit risk to emerge in 2016, it was abated by higher than normal crop production and reduced costs that supported stronger than expected net farm income. We anticipate some increased credit risk in 2017/18 given current conditions. Increased credit risk is likely in cash grain production, cattle feedlots, and dairy production across the Farm Credit System (System). Macroeconomic events are likely to further accelerate the risk conditions including:

1. *Monetary Policy* – The Federal Reserve Board's (FRB) actions to increase interest rates and reduce economic accommodations may cause short-term adjustments as policy changes take effect. This includes a gradual increase in short-term interest rates via the increased Fed Funds Rate, which have already increased 75 basis points in 2017. Interest rates will likely increase further—especially long-term rates—as the FRB begins selling some of its $4 trillion of U.S. Government securities. This has potential to impact both net farm income and collateral values since real estate values typically decline as interest rates increase.

2. *Energy Prices* – Crude oil prices are relatively low, but remain sensitive to tenuous foreign production controls and supply chain issues (e.g., refinery capacity impacted by Hurricane Harvey). This is a crucial risk factor impacting U.S. agriculture given its dependence on oil for fuel, fertilizer, chemicals, and transportation.

3. *Trade Agreements* – Trade agreements with critical U.S. export partners are being reviewed by the administration. Changes have the potential to distort the established market chains and create opportunities for other countries to vie for this marketplace. Absent stabilizing forces, this could distort established price discovery mechanisms and net farm income.

4. *U.S. Dollar* – The U.S. dollar's strength against foreign currencies directly impacts agricultural exports since it makes our products more expensive compared to other countries.

5. *Farm Bill* – A new 2018 Farm Bill may be formulated during this planning period. Crop insurance, a critical risk management tool for both producers and the System, is being increasingly scrutinized.

Given these events, institutions will need to be proactive and responsive by counseling customers, restructuring debts, and establishing stronger credit controls. In more severe cases, institutions may need to update their ability to handle this increased credit risk through Special Credit Departments and ensure all FCA Borrower Rights requirements are administered properly. Importantly, institutions must maintain the financial capacity and risk-bearing ability to "weather the storm" and work with borrowers experiencing stress. We fully expect System institutions will use their capacity to work with borrowers as they navigate a potentially stressful period.

The USDA issued a Farm Income Forecast on August 30, 2017, that forecasts some improvements over earlier expectations. Net Cash Farm Income is projected to increase 12.6 percent over 2016 with much of this improvement derived from prior period inventory sales and livestock revenues. The USDA also forecasts increased farm asset values in 2017 due to increased real estate values. The USDA's report is available at https://www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/highlights-from-the-farm-income-forecast/. The forecast, if proven accurate, should help mitigate some of the noted credit risk concerns. While this forecast provides some optimism for improving conditions, today's credit conditions still require institutions to be proactive and responsive as described above.

Internal Controls Over Financial Reporting

All System institutions, regardless of size or scope of operations, must have effective internal controls over financial reporting (ICFR or controls). Each institution's ICFR should include logical delegated authorities, clear segregation of duties, appropriate access controls to loan and accounting systems, and detective and corrective controls – including a highly effective internal audit program. Effective ICFR is paramount to safeguarding the integrity and accuracy of institution financial reports, as well as financial reports compiled at the bank and System levels. In addition, all institutions must have effective ICFR to ensure FCA Call Reports are accurate. System investors, shareholders, FCA, and the external auditor rely on these controls to safeguard the integrity of FCS financial reports and statements. An internal controls breakdown could have significant consequences and be very expensive to remediate. We commend System leadership and the System's Accounting and ICFR Workgroups for the focus on this area. We support these efforts and encourage every institution to dedicate staff and audit resources needed to ensure strong internal controls.

Areas of Continuing Focus

This memorandum also highlights other current issues important to the Farm Credit Administration. Two items of increasing concern deserving the boards of directors' and managers' attention include:

1. **Earnings Trends and Operating Expenses** – While the System's earnings performance remains strong, the return on assets is declining at some associations. In particular, the return on assets from local earnings (which excludes patronage income) has significantly declined at several associations in recent years. Rising operating expenses and efficiency ratios have contributed to this decline. An Informational Memorandum dated July 22, 2014, further described the concerns with rising operating expenses. We expect institutions to maintain a strong corporate culture in managing expenses. Business planning strategies should ensure growth in net interest income and other revenue is sustainable and sufficient to cover operating expense growth and maintain profitability.

2. **Stress Testing** – Stress Testing continues to be an important loan portfolio management and planning tool for System institutions. We expect institutions to continue to assess and, if needed, strengthen stress testing processes. An effective assessment would include emphasis on model validation to ensure the accuracy of your models' results. Depending on the complexity of the stress testing model used, third party validation may be necessary. When internal testing and validation is conducted, it must be completed by independent parties with sufficient scope and documentation to evidence the model is working appropriately. Also, as part of validation efforts, institutions should be back-testing or testing actual results against model output to assess its accuracy. Management should ensure model input and assumptions are documented and supportable. Such documentation should include evidence that assumptions used for a severe, yet plausible, scenario are sufficient to fully test the institution's ability to withstand a significant and sustained economic downturn.

Please use this information to understand our priorities for the upcoming year. This memorandum should be distributed to your 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.