Farm Credit Administration

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INFORMATIONAL MEMORANDUM

October 2, 2018

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Bank, Association, and Service Corporation[1]

From: Samuel R. Coleman, Director and Chief Examiner
Office of Examination

Subject: National Oversight Plan for Fiscal Year 2019

The Farm Credit Administration's Office of Examination 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 that you can consider them in your risk assessment and business planning processes. Although our message is similar to that of prior NOP communications, credit conditions in many agricultural commodities and enterprises continue to deteriorate. Some internal control breakdowns resulting in losses also continue to surface, elevating our level of concern.

That's why each institution's board of directors and management team should carefully assess the impact of these issues on the institution's financial and portfolio condition, resource needs, and strategic plans. I hope you find this information about our examination focus helpful in your planning processes.

We identified two NOP risk topics for 2019. They are Portfolio Risk — Navigating Rough Waters and Internal Controls — Three Lines of Defense.

Portfolio Risk — Navigating Rough Waters

Although the Farm Credit System's (System) condition remains sound, many borrowers have been operating in a difficult economic environment for the past several years, and borrower financial stress is elevated. Conditions have deteriorated further in 2018 as borrowers experienced rapidly declining commodity prices, increasing interest rates, and market uncertainty related to trade disputes. These issues directly affect net farm income and are largely outside the borrowers' and System's control.

[1] Collectively, Farm Credit System institutions excluding the Federal Agricultural Mortgage Corporation (Farmer Mac).

The potential for significant borrower operating losses in 2018 on the heels of several years of losses or minimal profits creates an uncertain operating environment for both borrowers and lenders. Market prices for most commodities including cash grains such as corn, soybeans, and wheat, as well as livestock have been hard-hit in recent months. Dairy margins are also stressed and this will likely accelerate ongoing structural changes as smaller and mid-sized producers exit the industry.

The USDA recently announced plans to provide up to $12 billion in assistance to farmers to temper the impact of trade issues. Based on the information available to date, it appears that producers of soybeans and pork — two commodities heavily impacted by recent trade disputes — will receive the largest share of the assistance.

There are many conditions that could weaken credit quality over the planning horizon. The following are some of the most significant ones:

- ***Low commodity prices*.** Increased supplies and policy actions that directly affect agricultural trade could cause commodity prices to decline further.
- ***Rising interest rates*.** The Federal Reserve Board continues to reduce economic accommodations that have existed since the 2008 recession.
- ***Declining real estate values*.** Although relatively stable over the past year, real estate values have already declined 10 percent to 20 percent from 2012 and 2013 levels. Further declines are likely if interest rates continue to increase and farm income falls further.

While we have emphasized these conditions in past National Oversight Plans, the extended period of low commodity prices is having an increased impact on System borrowers. Institution servicing and borrower actions to date have minimized any significant effect on the System's credit quality and condition. However, we are increasingly concerned that many of the readily available servicing options (such as debt rebalancing) have already been used and more significant actions may be required if conditions do not improve. As a result, our examination activities will continue to focus on loan servicing and accurate risk identification. With the emerging risks in credit quality, we will also focus on whether institutions are ensuring all borrowers are afforded their FCA Borrower Rights and longer-term financial solutions are in the best interest of the borrower and shareholders.

Internal Controls — Three Lines of Defense

FCA and the System have noted a limited, but increased incidence of internal control weaknesses that led to credit losses, increased operating expenses, and increased reputation risk. Many of the conditions underlying these events are directly related to inadequate internal controls. In other cases, strong controls existed, but individuals were still able to circumvent controls.

Therefore, the internal controls message I communicated last year remains the same. Regardless of size or scale of operations, all System institutions must have effective internal controls. This includes internal controls over financial reporting (ICFR) to ensure that financial statements are above reproach. System investors, shareholders, FCA, and external auditors rely on these controls to safeguard the integrity of System financial reports and the institutions themselves.

The System's leadership and its ICFR Workgroup have taken positive steps to strengthen disclosure programs and use an industry-standard framework (2013 COSO Internal Control Framework). This framework, along with the appropriate organization structure and the three lines of defense (operational management, risk management, and internal audit), must operate effectively for control objectives to be achieved.

We support System efforts to strengthen controls and encourage every institution to dedicate staff and audit resources to ensure a strong internal controls environment — starting with the board of directors to provide the proper "tone at the top."

FCA's 2019 examination activities will focus on internal controls and we will also be enhancing our examination program in this area. We are currently working with a consulting firm to assess our examination guidance, training, and practices for evaluating System institutions' internal controls.

At the same time, we plan to complete our initial ICFR review, which began in late 2018; to increase our focus on examination of information technology and related controls; and to continue evaluating the System's progress in strengthening disclosure programs.

Please use this information about our priorities for the coming year as you assess the risks in your operating environment. This memorandum should be distributed to your board members and discussed with the audit committee chair, other board committees, and your executive management team.

If you have any questions, please contact your examiner-in-charge or me at (703) 883-4246 (colemanr@fca.gov).