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FARM CREDIT SYSTEM

Farm Credit Administration Effectively Addresses Identified Problems

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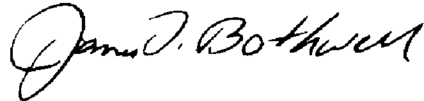
This report summarizes our review of how the Farm Credit Administration examines, monitors, and uses enforcement actions to regulate Farm Credit System institutions. It also addresses how the Farm Credit System Assistance Board, which expired December 31, 1992, ensured the ability of banks to repay assistance provided under the 1987 Agricultural Credit Act. In addition, this report discusses how the Farm Credit System Insurance Corporation (FCSIC), which became operational in January 1993, plans to fulfill the role of overseeing the assisted banks and protecting the Farm Credit System through its insurance fund.

This report was prepared under our statutory authority, not at the request of the Committees. This report is intended to provide information, analysis, and recommendations to improve Farm Credit Administration operations.

We are sending copies of this report to other interested congressional Committees, Farm Credit System officials, the Chairman of the FCA board, and the Chairman of the FCSIC board. Copies of this report will also be made available upon request.

This report was prepared under the direction of William J. Kruvant, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix VIII. If you have any questions about this report, please call me on (202) 512-8678 or Mr. Kruvant on (202) 728-5847.



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Executive Summary

Purpose

The Farm Credit System is a government-sponsored enterprise created by Congress to ensure a stable supply of credit to agriculture. It is a private system, cooperatively owned by its member-borrowers. The System holds approximately $62 billion in assets. It nearly collapsed in the mid-1980s, and the government provided financial assistance, which is being repaid. This history, the large losses in the thrift industry, and problems in banking prompted GAO to review the regulation of the System. To do this, GAO had to review the Farm Credit Administration (FCA), the Farm Credit System Assistance Board, the Farm Credit System Insurance Corporation (FCSIC), and System entities.

Background

Reacting to the System's financial problems during the mid-1980s, Congress enacted reforms to promote the System's safety and soundness. Congress changed the role of FCA to that of an independent, "arm's-length" regulator in 1985. The Agricultural Credit Act of 1987 provided financial assistance to the System and created the Assistance Board to administer the funds and FCSIC to ensure the payment of System obligations and to provide future financial assistance if it was needed.

The System comprises 258 cooperatively owned institutions operated for the benefit of their member-borrowers. It is organized into 11 districts, each with 1 Farm Credit bank and 1 or more lending associations. GAO reviewed how banks oversee their associations. In addition, there is one national bank for cooperatives serving cooperatives in all districts and two smaller ones, which also have national charters. System institutions make loans for agricultural production, equipment, real estate, and, with limitations, other agriculture-related businesses. The System raises its money by selling debt securities. The securities are the joint obligations of all System banks and do not have government guarantees.

Like other financial institutions, the Farm Credit banks and associations that make loans face risks. The risks include losses from borrowers' failure to repay their loans, changes in interest rates, poor management decisions, poor internal controls, and unfavorable economic conditions. System institutions are especially vulnerable to poor economic conditions because their loan portfolios are not diversified and the agricultural economy is cyclical in nature.

FCA is to issue regulations to implement the Farm Credit Act of 1971, as amended, and to examine System institutions for compliance with applicable laws and regulations and safe and sound banking practices.

FCA's mission, therefore, is similar to that of regulators of other financial institutions. However, bank regulation needs to be tailored to the unique characteristics of the Farm Credit System as a government-sponsored enterprise.[1]

The 1987 act established the Assistance Board to administer financial assistance to eligible System institutions. The Assistance Board provided funds to four banks, required them to address weaknesses as a condition of receiving the funds, and monitored their performance until it expired on December 31, 1992. FCSIC assumed the Assistance Board's duty to oversee the assisted banks when it became fully operational in January 1993.

The Federal Farm Credit Banks Funding Corporation issues, markets, and handles debt obligations for the banks. It determines, subject to FCA's approval, the amount, maturities, interest rates, terms, and conditions of participation in each issue of System-wide bonds and notes. GAO examined how the Funding Corporation monitors the performance of the banks.

Results in Brief

FCA's examination and monitoring of the banks GAO reviewed was generally comprehensive and timely and addressed issues of safety and soundness. FCA customizes its examinations and monitoring for each individual institution within a framework of minimum standards. FCA took strong, timely enforcement action against the six System banks GAO reviewed, and with one exception, bank progress in resolving problems has been good. Financial assistance to three of these banks and a recently improved agricultural economy have aided the banks, but FCA's strong enforcement actions and close monitoring were vital to their financial recovery. FCA has controls at the headquarters, regional, and field office levels that ensure that its quality standards are met. GAO makes some recommendations to further enhance FCA's regulation of the System and help ensure the future soundness of the System.

The former Assistance Board, in concert with FCA, helped the System's financial recovery by setting strict requirements for getting assistance and by advising and closely monitoring the performance of the assisted banks. FCSIC coordinated closely with the Assistance Board in preparing to assume oversight of the assisted banks. Working with FCA, FCSIC has developed procedures to assess an institution's need for assistance and to estimate the cost of liquidation. FCSIC plans to use FCA resources for this

[1]See Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

work. Unlike other financial institutions' insurers, FCSIC is not subject to the review of an inspector general or required to have an independent annual audit.

The Funding Corporation also has a need to monitor the System. Subject to FCA approval, it is required to determine the conditions for bank participation in the issuance of System-wide debt obligations. In February 1993, the System submitted to FCA and FCSIC a proposed Market Access Agreement that would establish conditions of participation. The agreement, which was developed by System banks and the Funding Corporation, proposes substantial changes to the role the Funding Corporation has assumed in monitoring banks and protecting the System from weak banks.

The law authorizes System banks to oversee their associations. How and to what extent banks use this authority vary, but GAO did not find that it hampered FCA's regulation of the System.

GAO's Analysis

FCA Customizes Examinations to Risks and Monitors Exam Quality

GAO found that FCA, within a framework of minimum standards, tailors its annual examinations and ongoing monitoring to each institution based on the institution's current condition and identified risks. FCA Examiners reviewed key safety and soundness issues, such as internal controls, and documented their work on the six System banks GAO reviewed. The problems FCA cited in the enforcement actions at the six banks had been identified by examiners through the regular examination and monitoring processes. (See pp. 39-82.)

FCA field offices ensure quality and reliability in their examinations through supervisory reviews, independent verification of annual examination results, and other techniques. FCA headquarters manages a peer review program in which FCA examiners review the work of examiners in another region. The program has contributed to examination quality, but FCA may conduct the reviews less frequently in the future. (See pp. 82-90.)

Some Lending Limits Do Not Promote Safety and Soundness

Lending limits vary for Farm Credit Banks and associations and banks for cooperatives. Concentrations of loans to one borrower by associations and banks for cooperatives pose a safety and soundness threat and should be restricted. Associations can lend 50 percent of their capital and surplus to one borrower or, under some circumstances, more. Lending limits for banks for cooperatives vary according to the type of loan, with 25 percent for term debt to cooperatives, 35 percent for seasonal debt, and an overall limit on lending to one borrower of 50 percent. In contrast, national banks are generally limited to lending 25 percent of their capital and surplus to one borrower. In July 1993, FCA lowered the limits for associations effective January 1, 1994. However, it is prohibited by the 1987 act from lowering the limits for the National Bank for Cooperatives, and FCA has not lowered the limits for the other banks for cooperatives. (See pp. 72-75.)

FCA Has Taken Timely, Strong Enforcement Actions, and Most Banks Resolved or Partially Resolved Their Problems

FCA used its enforcement powers to address the problems its examiners identified as serious threats to safety and soundness at the six System banks GAO reviewed. FCA's efforts to get banks to resolve their problems have been aided by the following external conditions: a political climate that supports strong regulation of financial institutions, the Assistance Board's oversight of assisted banks, and recent improvements in the agricultural economy. (See pp. 97-102.)

FCA took strong enforcement actions when it documented serious problems at the six System banks GAO reviewed. Officials of two of the banks cooperated with FCA, addressed the underlying causes of the banks' problems, and resolved the problems. FCA terminated actions at these banks. Three of the banks have made steady progress in addressing their problems, and FCA has appropriately modified the actions at those banks over the 1989 through 1992 period. Some long-term problems still exist at these banks, and FCA continues to monitor them closely. Problems persist at one of the banks. The bank's board and management disagreed with FCA's assessment of the bank's problems and did not make good progress in resolving them from 1989 through 1991. In 1992, FCA issued a new enforcement action against this bank. The bank has new leadership and is addressing its problems in a more comprehensive and cooperative fashion. (See pp. 102-108.)

Additional Oversight by the Assistance Board and Funding Corporation Was Useful to FCA and the System

The Assistance Board approved business and recovery plans for assisted banks, monitored their operations and financial performance, and coordinated with FCA. To ensure the banks' progress toward financial recovery, the Assistance Board required the assisted banks to take specific actions, such as maintaining adequate interest rates on loans. The federal financial assistance provided, the proactive role of the Assistance Board, and the enforcement actions and monitoring by FCA helped these banks in their recovery. (See pp. 110-114.)

Although the Funding Corporation serves primarily as the fiscal agent for the System, it also monitors the condition of the banks through its Market Access and Risk Assessment Program. The 1987 act required the Funding Corporation to establish conditions of participation for System-wide debt, subject to FCA's approval. In early 1993, the System, in consultation with the Funding Corporation, proposed a Market Access Agreement that would supersede the existing program and vest monitoring, analysis, and market access decisionmaking functions in a committee of the System. In addition, the System proposes that FCA and FCSIC be parties to the agreement, which is a self-disciplinary device. GAO believes that the regulatory power of FCA and FCSIC should not be impaired by any such agreement. (See pp. 118-127.)

FCSIC Will Use FCA Resources; Too Soon to Evaluate FCSIC's Effectiveness; Additional Oversight Needed

FCSIC, which became operational in January 1993, plans to monitor the activities of assisted banks in ways that are similar to those of the now expired Assistance Board. It plans to use FCA examination resources in monitoring, assessing the potential need for assistance in the future, and deciding whether to assist or liquidate an institution. Because FCSIC only recently became operational, GAO could not evaluate its effectiveness.

FCSIC will be subject to some outside review, but unlike the insurers for other financial institutions, it is not subject to the oversight of an inspector general or required to have an annual independent audit. (See pp. 114-118.)

Banks Continue to Oversee Associations but Do Not Interfere With FCA's Authority

Although FCA became the independent regulator of the System in 1985, banks continue to closely oversee the activities of their district associations. All banks oversee their associations, but the relationships between banks and associations differ in each district, reflecting bank management philosophy and district structure. Most of the bank officials GAO interviewed agreed that, although banks' powers over associations have not substantially changed, how they exercise these powers is

changing. Most strive for a debtor-creditor-type relationship that would require little bank involvement in association operations. However, banks still have substantial authority over many aspects of association operations, such as supervising credit operations and approving the appointment of chief executive officers and merger plans. The extent to which these authorities are used varies.

FCA and bank oversight overlap in certain areas, but coordination has prevented conflict. However, the potential for conflict remains. There is no disagreement within the System that FCA is the regulator and has the authority to require corrective actions at any institution. (See pp. 131-139.)

Recommendations

GAO recommends that Congress amend the Agricultural Credit Act of 1987

- to give FCA authority to set appropriate lending limits for the National Bank for Cooperatives (see p. 96) and
- to require that FCSIC be subject to the oversight of the FCA Inspector General and to have an annual independent audit of FCSIC's financial statements (see p. 129).

GAO recommends that FCA

- require annual peer reviews of the examination and monitoring work of field and regional offices (see p. 96) and
- in considering the proposed Market Access Agreement or similar proposals for approval, ensure its regulatory powers, including its duty to approve market access decisions and FCSIC's authority, will not be impaired (see p. 129).

GAO makes additional recommendations to FCA in chapter 2 to further enhance its regulation of the System. (See p. 96.)

Agency Comments

GAO requested comments on a draft of this report from FCA, FCSIC, and the System. The National Bank for Cooperatives also commented on the draft. The written comments of each entity and GAO's responses appear in appendixes IV through VII. FCA and FCSIC did not object to any of GAO's recommendations.

The System and the National Bank for Cooperatives objected to GAO's recommendation that Congress remove the statutory prohibition on FCA

setting lending limits for the National Bank for Cooperatives. They believe any change in the current limits is unwarranted. GAO continues to believe that FCA should have authority to set limits for the bank, just as it does for all other System institutions. (See pp. 74-75 and apps. V and VII.)

The System took strong exception to GAO's observations and recommendations concerning the proposed Market Access Agreement and the Funding Corporation's role relative to monitoring banks and denying or restricting market access. It believes the Funding Corporation will have a significant role in market access, monitoring, and decisionmaking under the proposed agreement and that FCA and FCSIC will retain their powers. FCSIC essentially expressed the same opinion. FCA noted several positive aspects of the proposed agreement. Subsequent to commenting on GAO's draft report, FCA tentatively approved the agreement contingent on several changes that addressed GAO's concerns. GAO continues to believe that FCA must ensure that its powers, and those of FCSIC, will not be impaired by the proposed agreement. (See pp. 124-127 and apps. IV and V.)

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Abbreviations

ACA	Agricultural Credit Association
C&D	cease and desist
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity management
CIPA	Contractual Interbank Performance Agreement
ED	Enforcement Division
EWS	early warning system
FCA	Farm Credit Administration
FCB	Farm Credit Bank
FCSIC	Farm Credit System Insurance Corporation
FICB	Federal Intermediate Credit Bank
FLB	Federal Land Bank
FLBA	Federal Land Bank Association
FLCA	Federal Land Credit Association
GFA	general financing agreement
GSE	government-sponsored enterprise
LARS	Loan Accounts Report System
MARAP	Market Access and Risk Alert Program
MAP	Market Access Program
NSAC	National Special Asset Council
OE	Office of Examinations
OIG	Office of Inspector General
OMB	Office of Management and Budget
PCA	Production Credit Association

Introduction

The Farm Credit System is a congressionally chartered enterprise that provides credit to farmers and farm cooperatives through a nationwide network of cooperatively owned institutions. The System nearly collapsed in the mid-1980s, but due to congressional actions, better management, more favorable economic conditions, and improved regulation of the System, it is recovering. The main changes mandated by Congress were mechanisms for financially assisting the System, encouraging organizational changes, and creating an independent, arm's-length regulator—the Farm Credit Administration (FCA). Both the System and FCA continue to evolve. As part of our ongoing duty to provide Congress with current information about financial institution regulators, we evaluated how well the System is being regulated and are making recommendations for its improvement.

Background

The System is a government-sponsored enterprise (GSE)—a private institution that is chartered by Congress to serve a public purpose.[1] Through a nationwide group of banks and associations, the System provides credit to farmers, ranchers, producers of aquatic products, cooperatives, and certain farm-related businesses. Congress established the following different types of System institutions as the need for credit became apparent: Federal Land Banks (FLB) in 12 districts in 1916, Federal Intermediate Credit Banks (FICB) and Production Credit Associations (PCA) in 1923, banks for cooperatives in 1933, and Federal Land Bank Associations (FLBA) in 1951. The System, like other GSEs, raises funds in the national capital markets on the strength of its ties to the federal government. The System's lending institutions hold $62 billion in assets and account for about one-fourth of the agricultural credit market.[2] Unlike most other GSEs, the System is cooperatively owned by its member-borrowers, who must buy stock in the System entities as a prerequisite for borrowing.

The System experienced severe financial stress in the mid-1980s caused by a combination of the following external and internal factors: deterioration of the agricultural economy, increased volatility of interest rates, and poor

[1]The major GSEs are financial institutions chartered by Congress to achieve the public purpose of facilitating the flow of funds to agriculture, housing, and higher education. In addition to the Farm Credit System, GSEs include the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Banks, and the Student Loan Marketing Association (Sallie Mae).

[2]As of February 1992, commercial banks and insurance companies supplied 35 and 7 percent, respectively, of agricultural credit. Individuals and others provided 20 percent, and the Farmers Home Administration provided 12 percent.

management practices. Agricultural markets expanded rapidly in the 1970s, pushing up commodity prices, land values, and farm income. At the same time, legislative changes liberalized collateral requirements, and System management sought to increase the System's market share.

In general, System banks priced their loans based on the average costs of their outstanding debt and offered all borrowers the same loan rate. As market interest rates rose during the 1970s and early 1980s, the System's pricing method allowed the System to price loans below competitors' rates based on an average of older low-interest debt and new high-interest debt. As a result, the System's loan volume and market share grew rapidly. The System financed this increased loan volume partly by issuing long-term, fixed-rate, noncallable securities. When market interest rates began declining in the mid-1980s, the System was locked into high-cost debt and was not able to lower its lending rates as quickly as its competitors. Many of the most creditworthy borrowers left the System and refinanced their loans elsewhere at lower rates.

As loan volume declined and credit quality deteriorated when commodity prices dropped, System institutions had to increase their reserves and hire more employees to service the troubled loans. Cash expenditures also increased as System institutions built new buildings. The System's organizational structure—more than 900 separate entities in the early 1980s with no centralized decisionmaking or accountability—also contributed to the problems. The System lost about $2.7 billion in 1985, lost $1.9 billion in 1986, and received a qualified opinion on its combined financial statements in 1986.

Federal regulation of the System was inadequate before 1986. FCA did not have its current enforcement powers—e.g., the authority to issue cease and desist (C&D) orders to remove management—or the monitoring or forecasting capability to learn about problems in time to prevent them from becoming serious. In addition, FCA could not set capital requirements for System institutions. Although FCA has overseen the System since 1933,[3] it was not established as an independent, arm's-length regulator until 1985. Before 1986, FCA delegated its authority to examine associations to the banks. Also before 1986, FCA functioned more like a part of the System than as its regulator. For example, the head of FCA appointed a member of each district's board of directors. FCA approved the interest rates that System banks charged for loans and was involved in other business decisions.

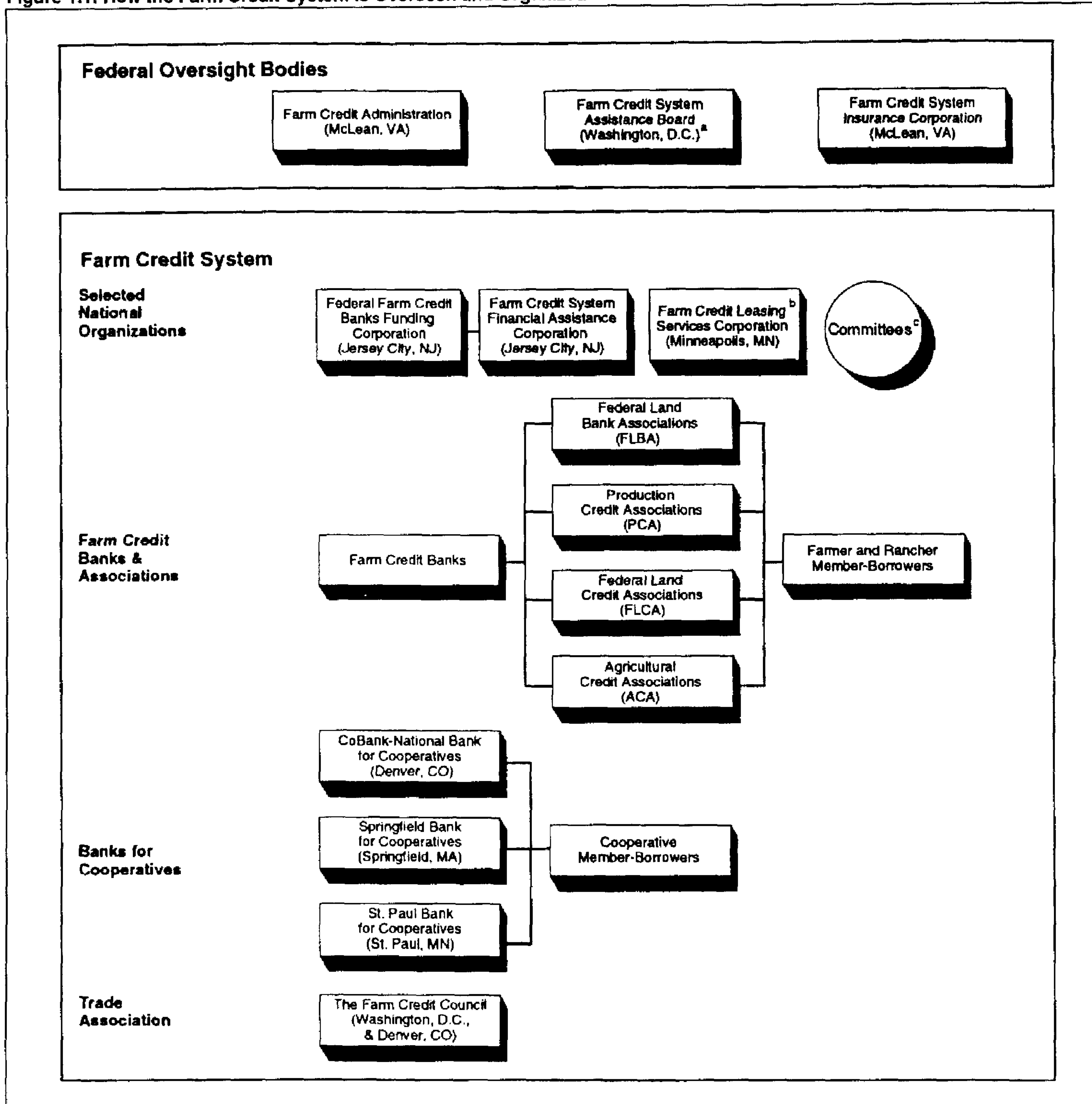
[3]The Federal Farm Loan Board supervised System institutions between 1916 and 1933.

While 1986 legislation made some changes in System operations, the major reforms that shaped the System as it is today were enacted in the Agricultural Credit Act of 1987 (P.L. 100-233, 101 Stat. 1568). This law mandated certain structural changes and encouraged others, provided financial assistance to the System, established the Farm Credit System Financial Assistance Corporation to provide the assistance, created the Farm Credit System Assistance Board to oversee the use of assistance funds, and established the Farm Credit System Insurance Corporation (FCSIC) to ensure the repayment of all System-wide debt.

System Continues to Consolidate, and Roles Have Changed

The System is a network of lending institutions organized in geographic districts and a group of specialized entities that facilitate or support the System's mission. The number of lending institutions has declined since the 1987 act took effect. In addition, many banks and their associations are striving for a more independent debtor-creditor relationship rather than being involved in the day-to-day management of association operations. In the 1987 act, Congress created new specialized entities—the Financial Assistance Corporation, the Assistance Board, and FCSIC—and changed or expanded the authority of others. See figure 1.1 for an organizational chart of the System.

Figure 1.1: How the Farm Credit System Is Overseen and Organized



(Figure notes on next page)

[a]The Farm Credit System Assistance Board expired on December 31, 1992, as provided for in the Agricultural Credit Act of 1987.

[b]This entity provides leasing and related services to eligible System borrowers, including agricultural producers, cooperatives, and rural utilities.

[c]These standing committees include the President's Planning Committee, which is composed of the presidents of System banks; the Funding Corporation; and the Farm Credit Council. This committee is not subject to federal oversight.

System Has Fewer Institutions and Fewer Assets

As shown in table 1.1, the number of System lending institutions declined from 427 in 1988 to 258 in 1992. Table 1.1 also presents the different types of System lending institutions. In general, the banks make loans to the associations, which in turn make loans to farmers, although banks can still make long-term real estate loans to farmers directly (but not in competition with an FLCA or ACA). Three banks for cooperatives lend to agriculture-related cooperatives and rural utility systems. All System institutions are owned by their borrowers, who elect boards of directors; each board elects one outside director. The banks raise funds by selling System-wide debt securities to investors through the Federal Farm Credit Banks Funding Corporation.

Table 1.1: Types of System Lending Institutions in 1988 and 1992

Institutions	1/1/88	10/1/92
Farm Credit Banks	0	10
Federal Land Banks	12	1[a]
Federal Intermediate Credit Banks	12	1
Banks for Cooperatives	13	3
Federal Land Bank Associations	231	76[b]
Production Credit Associations	159[c]	72[d]
Federal Land Credit Associations	0	29
Agricultural Credit Associations	0	66
Total institutions	**427**	**258[e]**

[a]The Jackson FLB was placed into receivership on May 20, 1988, and since then has not operated as a lending institution.

[b]This number includes an FLBA in liquidation.

[c]This amount includes eight production credit associations placed into liquidation from November 1983 through December 1987.

[d]This number includes the two PCAs placed in liquidation in January and April 1989.

[e]Certain pending corporate applications are likely to affect these numbers. These applications are the merger of the Federal Intermediate Credit Bank of Jackson into the Farm Credit Bank of Columbia, effective October 1, 1993; the transfer of direct lending authority to the Federal Land Bank Association of the Midlands, effective October 1, 1993; and, in June 1993, FCA received a letter of intent to merge from the AgriBank FCB and the Farm Credit Bank of Louisville.

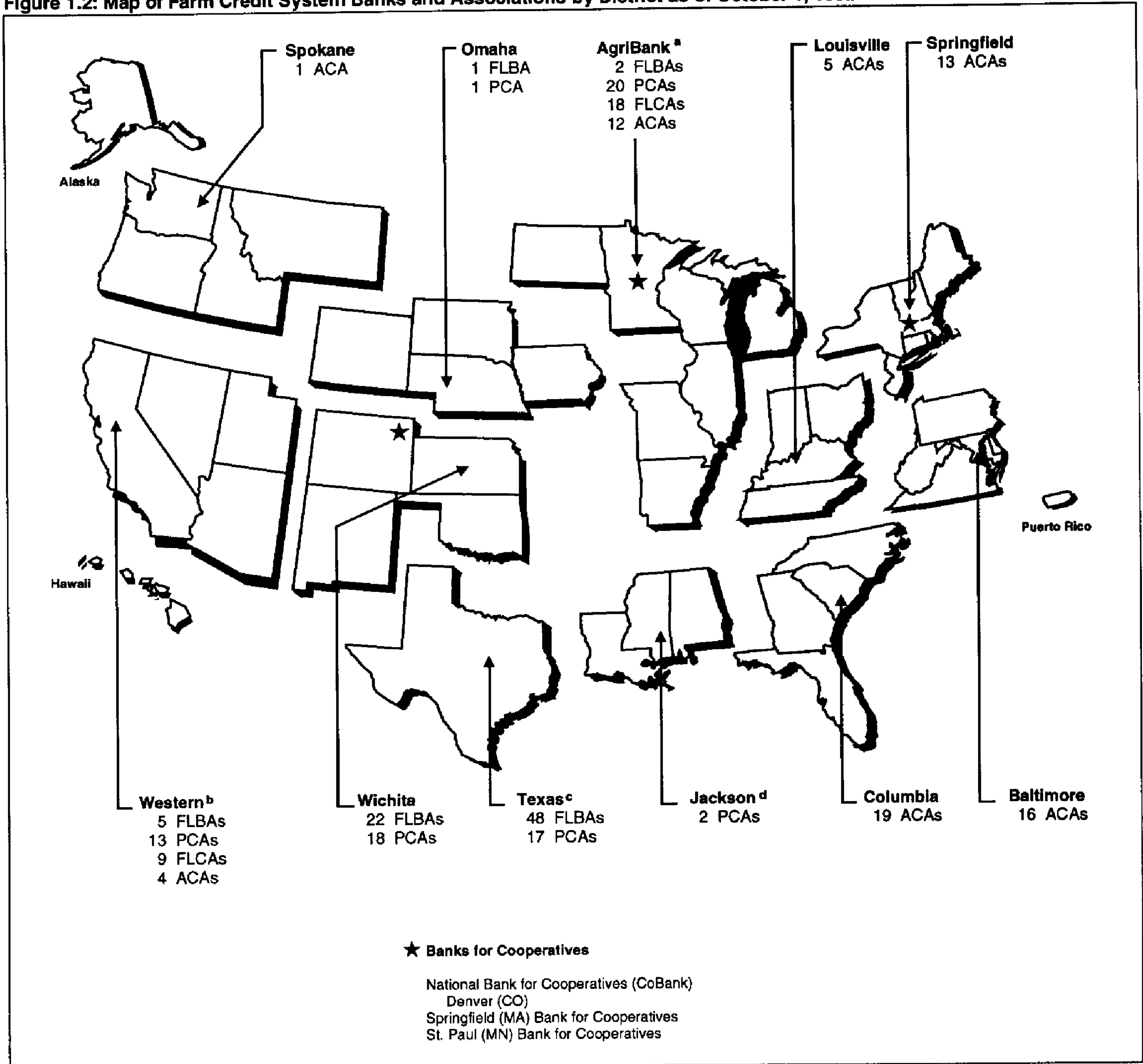
Source: Farm Credit System Annual Information Statement, 1991, and FCA data.

The 1987 act gave the System's district banks and associations the flexibility to organize in various ways. It required all FLBs and FICBs of each district to merge and form Farm Credit Banks. Banks for cooperatives and local associations were given the option of merging if their stockholder-borrowers and FCA approved. The 1987 act provided for the creation of a new type of association, formed by the merger of a PCA and FLBA, called an Agricultural Credit Association (ACA). The law also allowed the creation of Federal Land Credit Associations (FLCA) when banks transfer long-term real estate lending authority to FLBAS. However, FLBAS still exist in districts where this authority has not been transferred. The result is a highly diverse system with organizational structures ranging from 1 district with 1 bank and 1 districtwide association to one with a bank and 65 associations.

The first merger of 2 FCBs occurred in May 1992 when the St. Paul Farm Credit Bank, which had 37 associations, merged with the St. Louis Farm

Credit Bank, which had 23. The resulting 7-state territory includes 52 associations served by the new AgriBank FCB—now the largest FCB in asset size in the System. The System now comprises 11 districts, instead of the previous 12. See figure 1.2 for a map of System lending institutions.

Figure 1.2: Map of Farm Credit System Banks and Associations by District as of October 1, 1992



(Figure notes on next page)

[a]AgriBank was formed in May 1992 from the merger of the St. Louis and St. Paul FCBs, resulting in 11 System districts.

[b]The Western FCB also funds a PCA in eastern Idaho.

[c]The Texas FCB makes long-term loans in Alabama, Louisiana, and Mississippi. It also funds certain PCAs in New Mexico.

[d]The Jackson FLB is in receivership. The Jackson FICB is expected to merge with the Columbia FCB in 1993.

Source: FCA data.

The decline in total assets in the System (see table 1.2) reflects both shrinking total farm debt and the loss of market share during the financial crisis. The System's share of lending to agriculture declined from about 34 percent at its 1982 peak to the current 25 percent.

Table 1.2: Asset Size by System District and Banks for Cooperatives in 1986 and 1992

Dollars in millions

System districts and banks for cooperatives	1986[a]	1992
Springfield	$1,677	$2,100
Springfield Bank for Cooperatives	186	263
Baltimore	3,080	4,001
Columbia	6,165	5,133
Louisville	5,086	4,199
Jackson	3,550	548
St. Louis[b]	5,796	0
St. Paul[b]	9,430	0
St. Paul Bank for Cooperatives	1,172	1,611
AgriBank[b]	0	10,257
Omaha	6,288	4,381
Wichita	5,550	3,681
Texas	5,126	4,488
Western	8,636	5,580
Spokane	4,507	2,770
National Bank for Cooperatives[c]	5,133	12,678
Total	**$71,382[d]**	**$61,690[e]**

Note: Data are as of December 31, 1986, and June 30, 1992.

[a]The 1986 amounts include each district's former bank for cooperatives' asset amount.

[b]AgriBank resulted from the merger of the St. Paul and St. Louis FCBs on May 1, 1992.

[c]The 1986 amount is for the Central Bank for Cooperatives, and the 1992 amount represents the National Bank for Cooperatives, created by Central Bank's merger with 10 cooperative banks in 1989.

[d]This amount is higher than the total district assets reported in the 1986 Summary Report of Condition and Performance because it does not include interbank transactions.

[e]This total differs from reported combined System assets of $62.3 billion because it does not include approximately $600 million of restricted capital in the Farm Credit Insurance Fund.

Sources: Farm Credit Corporation of America, Summary Report of Condition and Performance of the Farm Credit System, December 31, 1986; Federal Farm Credit Banks Funding Corporation, Summary Report of Condition and Performance of the Farm Credit System, June 30, 1992.

Most Banks Moved Toward Becoming Wholesale Rather Than Retail Lenders

The roles of System institutions changed with System consolidation. Legislation sometimes facilitated the changes and sometimes required them. The 1987 act, however, permits most of the old roles to continue. For example, FCBs still have the authority to supervise their associations as

they did before the 1987 act. This traditional role could conflict with the greatly expanded regulatory role that the 1987 act gave FCA. System banks supervise associations in two ways—through monitoring activities and reviews. In addition, System banks have approval authorities over association operations, such as the authority to approve management salaries and policies and procedures.

Two key provisions of the 1987 act, in effect, encouraged banks to become wholesale lenders. One was the change in the status of borrower stock. The other was the way capital is to be counted for achieving the newly established regulatory minimum.

Borrowers must buy stock in a System lending institution to get a loan. Under the 1987 act, borrower stock issued before October 1988 was protected (i.e., System institutions were required to redeem it at par or face value, regardless of their financial condition). However, the act provided that this protected stock could not be counted as part of the bank's permanent capital. Borrower stock issued after October 1988 is at risk. Thus, the return on the stock and its value at redemption depend on the System institution's performance.

The way the regulations risk-weights capital makes it advantageous for banks to make loans to associations rather than directly to borrowers. Thus, changing its portfolio or moving from being a retail to primarily a wholesale lender would enable a bank to reach the regulatory capital ratio more easily. System banks did this, to varying degrees, by transferring farmers' loans to their associations. Loans to associations are weighted at 20 percent, whereas loans to farmers are weighted at 100 percent. A bank with most of its assets in lines of credit to associations could more easily reach the regulatory minimum. For example, if a bank held $4 billion in loans to farmers, it would need $280 million in capital to meet the current 7-percent requirement (100 percent of $4 billion = $4 billion x .07 = $280 million). If the same bank had its $4 billion in loans to associations, it would have to hold only $56 million in capital to meet the 7-percent requirement (20 percent of $4 billion = $800 million x 0.07 = $56 million). The law and implementing regulations required all System institutions to meet a minimum capital standard of 7 percent of risk-adjusted assets by January 1, 1993.

The current law gives banks the authority to supervise their associations and approve the salary scale of association officers and employees. Banks can also approve appointments and compensation of association chief

executive officers. FCA regulations require banks to supervise association credit operations, including setting standards for lending, operating procedures, and control mechanisms to ensure sound credit decisions. Other FCA regulations set broad parameters for loan policies and operations under which the banks issue specific guidelines. These requirements have existed since 1972 when banks supervised and examined associations. The 1985 act removed FCA's ability to delegate its examination authority and required that it annually examine all System institutions.

In essence, therefore, FCA and the banks both oversee associations. How each bank fulfills this role varies according to the nature of its relationship to its associations. Although FCA promotes the independent debtor-creditor concept, this type of relationship exists in varying degrees. Some banks supervise through oversight activities, such as reviews and monitoring, while others are closely involved in managing the associations. The overlapping roles of the banks and FCA afford the opportunity for mixed messages, inefficiency, or other problems. However, the overlapping roles may not be a problem if the banks and FCA complement rather than compete with each other. We explore whether their overlapping authorities actually cause regulatory problems in chapters 2, 3, and 5.

Most Banks for Cooperatives Merged and Now Have Expanded Powers

The System's banks for cooperatives have largely consolidated and Congress has expanded their powers. Before 1989, there was a bank for cooperatives in each of the 12 System districts, plus the Central Bank for Cooperatives, which, among other things, handled international lending and loans in excess of the district banks for cooperatives lending limits. The 1987 act permitted but did not require mergers of these banks. On January 1, 1989, 10 of the 12 district banks for cooperatives and the Central Bank merged to form the National Bank for Cooperatives, known as CoBank. The Springfield and St. Paul banks for cooperatives chose not to merge.

The three banks for cooperatives make loans nationwide to agricultural and aquatic cooperatives and to rural utilities. Like other System lending institutions, these banks are owned by their member-borrowers (other banks for cooperatives may own stock also) and governed by boards composed of the members and outside directors. Like all System banks, the banks for cooperatives must repay portions of the financial assistance provided under the 1987 act.

CoBank has a unique position in the System because it makes loans to finance the export of cooperatives' products and provides international banking services related to that financing for the benefit of U.S. farmer-owned cooperatives. CoBank's size—it holds about 20 percent of the System's assets—makes its financial health critical to the System. CoBank's international loans represent about 30 percent of its portfolio; 42 percent is concentrated in agribusiness loans and the balance, in rural utilities and in loan participations with other System banks. CoBank's international lending authority expanded in recent years as political developments have changed the world market. For example, CoBank gained the authority to finance U.S. commodity sales to Russia without the requirement that the exports originate from cooperatives. Virtually all of CoBank's international loans are guaranteed by the U.S. Commodity Credit Corporation.

To achieve its stated mission of becoming the "premier cooperative bank serving rural America," CoBank has expanded its lending and customer base. Congress granted banks for cooperatives, including CoBank, the authority to finance rural water systems and the export of products that do not originate from agriculture related cooperatives. In addition, CoBank now provides interest-rate risk management products to its customers.

We reviewed how FCA examines and monitors CoBank because of its unique role and size. Our assessment is included in chapters 2 and 3.

New System Entities Have Roles in Ensuring Financial Health

Congress created two temporary entities to carry out the assistance program it authorized in the 1987 act. It also created a permanent insurance corporation, FCSIC, to ensure repayment of System-wide debt and financially assist institutions in the future. Also, Congress established the Federal Farm Credit Banks Funding Corporation in the 1987 act to, among other things, determine the terms and conditions under which banks can participate in issuing System-wide debt.[4] The Assistance Board, FCSIC, and to a lesser degree the Funding Corporation play important roles in the financial health, safety, and soundness of the System. The now-expired Assistance Board and FCSIC have regulatory powers. Our evaluation of how their activities have affected or may in the future affect the System and how they interact with FCA, the regulator, is the focus of chapters 4 and 5. A brief introduction to each entity follows.

[4]In addition to the new duties established by the 1987 act, the Funding Corporation inherited other powers of the predecessor Funding Corporation.

Farm Credit System Assistance Board and Farm Credit System Financial Assistance Corporation

The 1987 act established the Assistance Board to administer financial assistance to eligible System institutions. The Secretaries of the Treasury and of Agriculture and an agricultural producer nominated by the President with the advice and consent of the Senate formed its board of directors. The Assistance Board authorized a total of $419 million in capital assistance to four system district FCBs: Louisville, Omaha, St. Paul, and Spokane. It recommended that FCA place the Jackson Federal Land Bank in receivership and authorized $388.2 million to liquidate the bank.

The Assistance Board set requirements and performance standards for the assisted banks and monitored their compliance closely. It had the authority to issue regulations and to request that FCA exercise its enforcement powers. In these respects, the Assistance Board's duties overlapped those of FCA. The Assistance Board focused on financial performance, while FCA primarily focused on the related area of safety and soundness.

The assisted banks are expected to redeem their capital assistance, but all of the System banks are obligated to pay for the aid some of the banks gave to others before 1987 and the interest on the debt issued to fund all financial assistance.[5] FCSIC will repay the principal portion of the debt associated with liquidating the Jackson bank. The total of these obligations plus a small amount Congress authorized for other purposes is $1.261 billion. A future report of ours will address the banks' ability to meet these obligations and remain healthy. The Assistance Board expired on December 31, 1992, and the new insurance corporation—FCSIC—assumed the responsibility for administering the outstanding assistance agreements and, if needed, will provide future financial assistance to System institutions.

Congress created the Farm Credit System Financial Assistance Corporation to raise the funds used for assisting System banks. The Financial Assistance Corporation was authorized to issue, with approval from the Assistance Board, up to $4 billion in Treasury-guaranteed, 15-year bonds. It actually issued $1.261 billion, as we noted earlier. Treasury is advancing some of the interest that is due on the debt during the first 10 of the 15 years that the debt is expected to be outstanding. This advance reduces the effective cost to the System of repaying the $1.261 billion in assistance. The Financial Assistance Corporation has the same governing board and shares the staff of the Funding Corporation, which we will discuss later in this chapter.

[5]In 1992, two of the four assisted System banks arranged to pay off their assistance early.

FCSIC

FCSIC's primary purpose is to ensure the timely repayment of principal and interest on all System-wide debt and, if needed, to assist System banks in the future. Beginning in 1989, banks began paying insurance premiums based on the performance and volume of loans made to farmers in their territories. FCSIC's board of directors now consists of the same three presidentially appointed members as the FCA board; the board elects one of its members as chairman (who cannot be the FCA chairman).[6] When FCSIC became fully operational on January 1, 1993, it assumed the Assistance Board's duty to oversee assisted banks. FCSIC has the authority to issue regulations and to examine any System institution. Some System officials expressed concern that FCSIC will duplicate the work of FCA. We address this issue in chapter 4 as well as how FCSIC will monitor assisted banks and those that may require assistance.

Federal Farm Credit Banks Funding Corporation

The Federal Farm Credit Banks Funding Corporation is the fiscal agent for the System. In the 1987 act, Congress required it, subject to FCA approval, to determine the conditions under which banks can participate in debt issuances.[7] As a result, the Funding Corporation established a program to monitor the financial health of the System. Its board of directors includes both leaders of System institutions and outsiders.

The Funding Corporation markets the Farm Credit System debt securities. It determines, subject to FCA approval, the amount, maturities, rates of interest, terms, and conditions of participation of the securities offered. This System-wide debt is not guaranteed by the government. System-wide debt securities are joint and several obligations of all System banks. The Funding Corporation also provides financial advisory services to banks, especially in the area of managing interest rate risk. It is responsible for the System's financial disclosure and serves as the official source for System financial information.

The 1987 act required the Funding Corporation to determine conditions of bank participation in the offerings. The Funding Corporation established a program to measure and monitor bank performance in response to this mandate. The program has been updated occasionally, but its basic purpose remains the same: to determine if each bank should be allowed to raise funds through issuing System-wide debt. Strong banks, therefore, can be protected from becoming exposed to debt incurred by weaker banks.

[6]The Farm Credit Banks and Associations Safety and Soundness Act of 1992 (P.L. 102-552, 106 Stat. 4102) provided for a separate three-member board to be appointed by the president in 1996.

[7]Before the 1987 act, a subcommittee of the System's bank Presidents' Finance Committee and the head of FCA set the terms and conditions of participation.

The Funding Corporation is owned by the System banks and governed by a 10-member board.[8] System banks elect four members from among the current or former bank directors and three from bank presidents or chief executive officers. These seven members appoint two members from outside of the System after consulting with the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System. The Funding Corporation president serves as a nonvoting member. Our assessment of the Funding Corporation's efforts and how its monitoring role compares with that of the Assistance Board, FCSIC, and FCA is covered in chapter 4.

Congress Gave FCA a New Role After Crisis

The 1985 act established FCA as an arm's-length regulator with enforcement powers that essentially parallel those of regulators of other federal financial institutions. It issues regulations to implement the Farm Credit Act of 1971, as amended, and examines System institutions for compliance with applicable laws, regulations, and safe and sound banking practices. Before 1986, FCA functioned as part of the System; it approved interest rates charged on loans and named a member to each System district's governing board, for example. It had limited powers for dealing with financially troubled institutions. FCA's task to redefine itself during the System crisis was formidable, and FCA continues to face significant challenges in regulating the ever-changing System. This review is our first comprehensive look at how adequately FCA is fulfilling its new regulatory role.

Before the Farm Credit Amendments Act of 1985 (P.L. 99-205, 99 Stat. 1678), FCA was governed by a part-time 13-member board. Twelve of the members were appointed by the president from nominations submitted by the 12 System districts and confirmed by the Senate. One member was appointed by and "served at the pleasure" of the Secretary of Agriculture. The board appointed a governor who served as the agency's chief executive officer. FCA promoted the System and was its spokesperson as well as its regulator. This arrangement was similar to that of the now defunct Federal Home Loan Bank Board that both promoted and regulated the savings and loan industry before the industry's collapse. However, unlike FCA, the Bank Board had enforcement powers.

The new FCA is governed by a salaried, full-time, three-member board appointed by the president with the advice and consent of the Senate. All

[8]The Assistance Board had a nonvoting representative on the Funding Corporation's board. FCSIC will not have a representative on the board.

members serve 6-year terms, and no more than two of them can be from the same political party. The president designates the board chairman, who by law serves as the agency's chief executive officer. Board members cannot be employees of any System institution during their tenure and for 2 years afterward. The 1985 law stated only two qualifications for the members: They must be U.S. citizens and "broadly representative of the public interest." The Farm Credit Banks and Associations Safety and Soundness Act of 1992 added that board members should be experienced or knowledgeable in agricultural economics and financial reporting and disclosure; be experienced or knowledgeable in the regulation of financial entities; or have strong financial, legal, or regulatory backgrounds.

Congress gave the new FCA enforcement powers that essentially parallel those of other federal financial institution regulators: powers to issue cease-and-desist orders, suspend or remove officers or directors, and assess civil money penalties. FCA retains its previous powers to require financially troubled institutions to merge or to liquidate them. Also, FCA can still regulate the borrowing, repayment, and transfer of funds and equities between System institutions. The law still permits loss-sharing agreements among institutions, and FCA insists on approving such transactions because they amount to providing financial assistance. As discussed earlier, as of January 1993, the System's insurance fund can be used to assist System banks when FCSIC deems it appropriate.

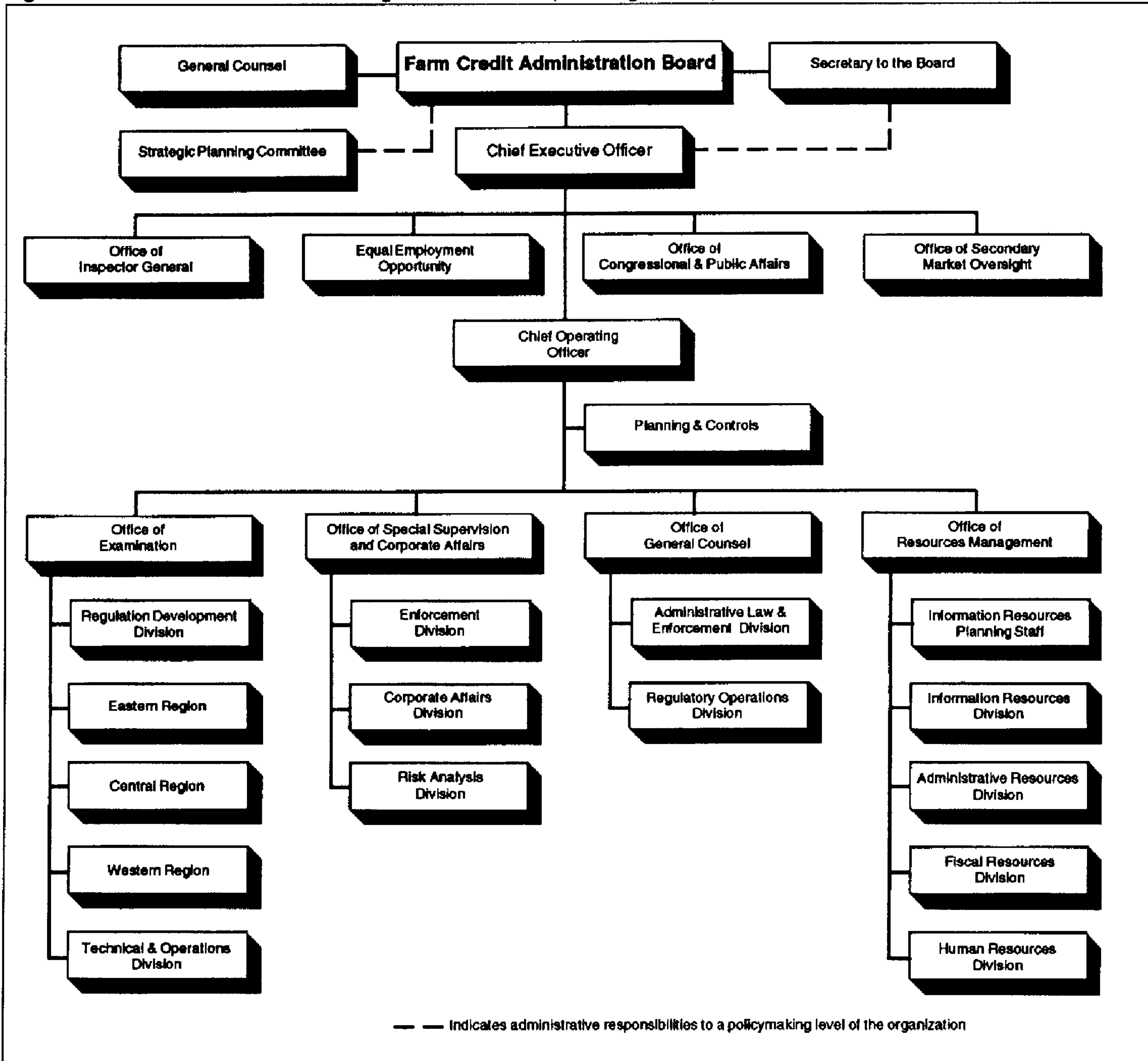
In addition, Congress required FCA to set minimum capital standards for System institutions and improved financial reporting requirements. The lack of consistent and reliable financial data was evident during the System's crisis and made it difficult for the System and Congress to determine the true extent of the problem. FCA began requiring quarterly reports of financial condition and performance (call reports) from all System institutions in 1986. These reports are similar in content to those required by other financial institution regulators.

FCA was required to set standards for lending and disclosure to shareholders and was given the authority to approve the issuance of all System debt. FCA must examine all System institutions each year except FLBAS, which are not direct lenders and must be examined only every 3 years.

To fulfill these and other duties, FCA currently has a staff of 443, 59 percent of whom are examinations staff based in headquarters and 3 regions, (see figure 1.3 for FCA's organizational chart). FCA is funded by the Farm Credit

System; it does not receive any public funds. FCA assesses institutions for the costs of regulating the System. The costs are apportioned "on a basis that is determined [by FCA] to be equitable." Its fiscal year 1993 is $39.9 million.

Figure 1.3: Farm Credit Administration Organizational Chart (as of August 1993)



Source: FCA data.

To establish itself as an arm's-length regulator during the financial crisis was a formidable task for FCA. It had to adjust, and still does, to the evolving relationships banks have with their associations. It had to coordinate with the Assistance Board and the newly chartered Funding Corporation. These factors and the System's GSE status make FCA's work different from that of other regulators. In chapters 2 and 3, we present our findings and recommendations for improvements.

Objectives, Scope, and Methodology

The overall goal of our review was to determine how well the System was being regulated under the 1987 act and other legislation that has been enacted since the 1980s crisis. We were to determine if and where any problems existed that might impair the regulator's effort to ensure the safety and soundness of the System and to effectively address them. The specific objectives of this review were to determine (1) how effectively FCA regulates the System; (2) how the Assistance Board, which expired on December 31, 1992, ensured the ability of assisted banks to repay their assistance; and (3) how FCSIC, which became fully operational January 1, 1993, will carry out its role in protecting the System through its insurance program and oversight of the assisted banks. To meet these objectives, we also determined how banks oversee their associations and how the Funding Corporation monitors the performance of the banks.

Although System banks are somewhat similar to other financial institutions, they are quite different because the System is a GSE and it does not comprise depository institutions. Two fundamental differences between banks and most GSEs indicate a need to tailor bank regulatory elements to the specific GSE circumstances.[9] First, many of the depositors that use banks are generally less sophisticated than the large investors that buy GSE securities. Second, thousands of banks, thrifts, and credit unions operate with federal guarantees. The supervision, monitoring, and enforcement rules must cover the variety of circumstances that could be practiced by so many financial institutions. In contrast, the Farm Credit System comprises fewer nondepository institutions, operates a single line of business, and serves a single market. Thus, FCA regulation can legitimately reflect these differences, and FCA's rules need not be so detailed that they cover every conceivable circumstance.

We organized our review of FCA's regulatory activities into five major components. In the first component, we assessed the laws, regulations,

[9] See Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

and FCA guidance. In the second component, we included reviews of examination reports, selected workpapers, and other examination-related documents. In the third component, we reviewed how FCA monitors System institutions between its annual on-site examinations. In the fourth component, we determined what quality controls FCA had over its examination and monitoring processes. The final component was an assessment of FCA's enforcement activities.

We built our assessment of the relevant laws, regulations, and guidance around these safety and soundness issues: capital, internal controls, external and internal audits, financial reporting, standards of conduct, and lending and investing practices. In several of our GAO studies on the regulation of banks, thrifts, and credit unions, we have discussed the importance of these issues, described typical deficiencies, and discussed appropriate standards. Deficiencies related to these issues have been associated with problem and failed financial institutions. For example, we found that without the discipline of an audit, troubled institutions are more able to cover up their financial difficulties. We believe annual independent audits are a critical component of corporate governance and can enhance the effectiveness of the examination and supervision process. The regulator should review the annual independent audit and consider its results in examining and monitoring the institution. The regulator should review any management letters issued by auditors and follow up on management's response. We reviewed the relevant laws and regulations related to audits of System institutions and FCA's guidance to examiners. We compared these provisions to our established criteria.

In addition to the safety and soundness issues that we listed earlier, we reviewed two System-specific issues, loan pricing and borrower rights compliance. We selected loan pricing because problems in this area were at the core of the System's financial distress (as we discussed earlier in this chapter) and because some competitors have accused the System of engaging in below-cost and prevailing market rate pricing or predatory pricing because it received federal financial assistance. We selected borrower rights compliance because the 1987 act contained special provisions to ensure borrowers would be treated fairly as the System recovered and changed.

Next, we reviewed FCA examination, monitoring, and enforcement documents for five FCBs and CoBank. We judgmentally selected the banks to include both assisted and unassisted banks, FCA-rated problem banks, and banks with better FCA ratings. We included CoBank because of its size

(i.e., it holds about 20 percent of System assets) and its unique role in the System. The assets of our sample banks totaled $36 billion, 57 percent of the System's assets in 1992. Although our results cannot be projected to the System as a whole, FCA's handling of these large and troubled institutions is a good indicator of how it regulates the System.

We analyzed what the FCA examiners did compared with FCA requirements and our standards. We reviewed the 1989, 1990, and 1991 examination reports, selected workpapers, and other documents. We also reviewed selected examination plans. We talked with examiners and other FCA officials about our findings and the problems of the six selected banks. We documented the nature and extent of the problems an examiner identified, whether the examiner required the institution to correct the problems, the institution's response, and FCA's subsequent action. Therefore, we initially evaluated examinations and their effects within a 3-year period. We updated our work by reviewing 1992 and some 1993 examination reports and monitoring documents. Thus, we evaluated FCA's oversight of six banks over at least a 4-year period.

Monitoring financial institutions in between annual on-site examinations is an integral part of regulatory oversight. We again drew on our previous financial institutions work to identify appropriate standards. Monitoring should be timely, focus on previously identified problems, and identify potential problems. If the regulator identifies emerging problems, he or she should pursue them by contacting or visiting the institution or taking other appropriate action. Information obtained through monitoring should be considered in planning the next examination.

We reviewed FCA's monitoring of the six sample banks over the 1989 to 1992 period. In addition, we reviewed monitoring files at 4 FCA field offices for 16 other judgmentally selected institutions. We compared these records to both our standards and FCA's own monitoring guidance and discussed our findings with examiners and other FCA officials.

In the fourth component of our review, we assessed FCA's efforts to ensure quality in its examination and monitoring processes. Regulators of financial institutions should have an appropriate internal quality control system and be assessed periodically by an independent party. FCA has such a system, and we reviewed its standards, such as its supervisory review of examination workpapers. To assess FCA's compliance with its standards, we reviewed 1991 records in four field offices and interviewed staff representing five field offices and two regional offices. We also reviewed

the results of the FCA Office of Examinations' (OE) 1992 internal peer review. FCA also undergoes evaluations and investigations by its independent Office of Inspector General (OIG). We reviewed 1990 through 1992 OIG audits related to regulatory activities and how FCA responded to the resulting OIG recommendations.

Our evaluation of FCA's use of enforcement actions was based on criteria we established in reviewing other regulators of financial institutions. For example, strong enforcement action should be taken promptly when a regulator identifies serious problems. The action should address all such problems and set specific time frames for compliance. The regulator must actively monitor an institution's compliance. To determine if FCA ordered institutions to correct their serious problems, we tracked examiner-identified problems at the six banks for the 4-year period 1988 through 1992 for four banks and the 3-year period 1989 through 1992) for two. To track the problems, we used examination reports, FCA internal memos, and the enforcement documents. By reviewing the examination reports and other documents that preceded and followed the enforcement actions, we tracked each bank's response to the examiner-identified problems and FCA's assessment of whether the problems were being addressed adequately. We also reviewed 1993 information on the six banks as appropriate. Although we did not independently verify FCA's assessment, we looked for inconsistencies with other information that might cause us to question its judgment. We considered, for example, the Funding Corporation's assessment. When the Assistance Board was involved, we documented what it required of the three assisted banks in our sample and considered the effect of those requirements on FCA's enforcement efforts. We also considered FCA's opinion in light of financial performance ratios and our cumulative knowledge of each of the six sample institutions.

In evaluating the work of the Assistance Board, we reviewed its contractual agreements with all assisted banks, its correspondence with three of the four assisted banks and the one unassisted bank, and reports and other documents these banks submitted to the Assistance Board. To understand how our selected banks oversee their associations, we reviewed their guidance to associations, the banks' supervisory or monitoring programs, and related documents. To understand how the Funding Corporation measures bank performance, we reviewed the monitoring programs that were in effect and under development from 1989 through 1993 as well as the information it received from the banks.

To assess how the Assistance Board performed its function of ensuring the ability of assisted banks to repay their assistance and monitoring the performance of any troubled institution, we reviewed various monitoring documents from 1990 through 1992. To determine how the Assistance Board performed its oversight responsibilities, we reviewed monitoring guidelines, plans, files, and reports. We also reviewed any addenda or amendments to the original contractual agreements. To assess the level of communication between banks and the Assistance Board, we reviewed correspondence files from 1989 through 1992. We found that instead of issuing regulations, the Assistance Board specifically addressed items in each assisted bank's contractual agreement and directed monitoring efforts to problem areas depending on each bank's needs. Because FCSIC began operating in January 1, 1993, we were able to review only its action plan and proposed examination procedures for FCA examiners.

To assess the monitoring efforts of the Funding Corporation, we reviewed information obtained through the monitoring program as well as the disclosure program. We reviewed selected monitoring reports from 1990 through 1992 for all of the System banks. To determine how the Funding Corporation monitored bank performance, we reviewed variance reports that compared 1990 and 1991 performances. We also reviewed reports of the Funding Corporation's System Audit Committee, which monitors the System's internal and administrative accounting controls.

To assess the extent of banks' oversight of association activities, we reviewed bank supervision programs, including selected review reports, monthly and/or quarterly monitoring activities, bank policies and procedures manuals, and training activities. For selected associations, we compared the banks' review findings for the same period with FCA's examination findings to determine whether conflicts existed.

We interviewed officials at the selected System banks and other entities, such as the Funding Corporation and the Assistance Board, to gather information on their various oversight activities. To broaden our perspective on the System, we also met with members of the System's Presidents' Planning Council, which includes representatives of all of the System banks, and with officials of the Farm Credit Council, the System's trade association.

Our review was done from November 1991 through February 1993 at FCA and FCSIC headquarters in McLean, VA; FCA field offices in Bloomington, MN; Denver; Sacramento, CA; Atlanta; and the Omaha/Oklahoma City field

office in Oklahoma City, OK, (those responsible for our selected banks); FCBs in St. Paul; Spokane; Sacramento, CA; Columbia, SC; and Omaha; CoBank in Denver; the Funding Corporation in Jersey City; and the Assistance Board in Washington, D.C. Our work was done in accordance with generally accepted government auditing standards.

We requested comments on our draft report from FCA, FCSIC, and the System. CoBank also commented on the draft. We incorporated comments in the text where appropriate. In addition, the full text of each entity's comments and our responses are provided in appendixes IV through VII.

FCA Identifies Bank Deficiencies Through Examinations and Monitoring

FCA customizes its examinations and monitoring to the risks it perceives at each System institution within a framework of minimum standards. Examiners look at key safety and soundness issues, identify deficiencies, and require that the institutions take appropriate corrective actions. The bank examinations and monitoring we reviewed were generally comprehensive and timely and addressed key safety and soundness issues. FCA has controls at headquarters, regional, and field office levels to ensure that its quality standards are met. Its internal peer review program and the work of its OIG have resulted in recent improvements. We make recommendations that we believe will further enhance FCA's regulatory effectiveness and promote continued improvements in the System.

Overview of Regulatory Process

FCA's regulatory process is a continuous cycle of planning each individual oversight program and examining and monitoring each System institution. FCA customizes each institution's examination to risks it identified through the previous annual examination and current monitoring activities. When examinations are completed, examiners present a written report of the examination, including any requirements for correcting deficiencies, to the institution's board of directors. If enforcement action is warranted, examiners recommend the type of action and specific provisions that should be taken. The FCA board must approve any enforcement actions. All nine members of the headquarters Enforcement Division (ED) staff work at FCA's McLean, VA, headquarters. Examiners, other field staff, and the ED oversee compliance with enforcement actions. We discuss FCA's enforcement actions in chapter 3.

FCA's OE has a staff of 263, 88 percent (232) of whom are based in field or regional offices. OE's nine field offices are organized in three regions.[1] Associate Regional Directors head field offices and report to the Director of OE through the respective regional directors. (See fig. 1.3.)

Unlike the laws governing most financial institution regulators, which do not always require them to do annual examinations, the law requires FCA to examine every institution annually regardless of size, except FLBAS, which it must examine at least every 3 years.[2] FCA records show that FCA completed all required annual examinations in fiscal years 1991 and 1992.

[1]The Eastern Region comprises field offices in Albany, NY; McLean, VA; and Atlanta; the Central Region comprises offices in St. Louis; Bloomington, MN; and Oklahoma City; and the Western Region comprises offices in Dallas; Sacramento, CA; and Denver. Effective March 1995, FCA will close its Albany and Oklahoma City field offices.

[2]FLBAs do not make direct loans to farmers; they service loans made by the banks. Risks, therefore, are at the bank level, and the lack of annual exams is not a threat to safety and soundness.

In 1990 and 1991, the FCA's OIG determined that FCA was examining institutions as required by law. FCA's standard for timely issuance of bank exam reports is 90 days after the examination's "as of" date and 65 days for other institutions.[3] Our review of FCA records for fiscal years 1991 and 1992 examinations showed that, with some minor exceptions, reports were issued on time.

Examinations Are Customized to Institutions

FCA customizes its examination of each institution on the basis of risk identified by previous examinations and current monitoring activities. Until late 1992, the law set requirements for the scope of FCA examinations. Examinations had to assess the institution's

- credit and collateral quality,
- capitalization,
- management,
- ability to carry out requirements of the Farm Credit Act of 1971 as amended, and
- ability to service all eligible borrowers.

The Farm Credit Banks and Associations Safety and Soundness Act of 1992, signed on October 28, 1992, permits FCA to decide what the scope of an examination will be and will include the aforementioned elements as appropriate. At its July 15, 1993, meeting, the FCA board adopted a policy statement implementing this new authority. It provides that examinations of direct lenders will be consistent with legislative authorities and statutory requirements while addressing the risk-based nature of the examinations. The benefit of the change, according to an FCA official, is that it allows FCA more flexibility in using its resources; any limiting of scope would only occur at the strongest institutions. However, OE does not anticipate any drastic change in the examination program. Examinations would still have to meet FCA standards to address an institution's safety and soundness. At a minimum, they must ensure an institution's compliance with laws and regulations related to capital, internal controls, audits, financial reporting, standards of conduct, lending, investments, loan pricing, and borrower's rights.

Examiners primarily rely on FCA's Examination Manual to design examinations. The manual presents basic examination and analytical techniques and includes pro forma workpapers. FCA officials emphasized

[3]The "as of" date refers to the closing date of the financial records examined. For example, if this date were June 30, examination field work would be completed several weeks after June 30 and the report would be issued by September 30.

to us that the manual is a guide; the techniques and workpapers do not have to be used by examiners as long as all of the FCA examination requirements are met. The officials said that the level of expertise of FCA's examination staff has surpassed the fundamentals described in the manual and acknowledged that the manual, much of which dates from about 1988, is out of date. For example, a typical examiner's analysis of asset-liability management is more sophisticated than the manual suggests. Examiners usually create electronic workpapers instead of completing those forms in the manual. If available staff resources permit, OE plans to revise the manual by January 1994. The manual is supplemented by other guidance (i.e., OE operations directives, examination bulletins, management letters, FCA bookletters)[4], which is issued by FCA, as needed.

The manual states that examiners must decide which institution activities need the most attention by identifying and ranking the risks. Examination plans illustrate the customized nature of FCA examinations. For example, the examination plan for one bank noted the examination would focus on asset quality and financial condition because asset risk was the most significant threat to that district. The plan commented that the bank's large volume of high-risk assets limited its ability to generate earnings and threatened existing capital. Of the 534 examination staff days planned for that bank, FCA allotted 275 to asset quality issues. For another bank, the examination plan emphasized the quality of management, its compliance with FCA's enforcement actions, and its agreement with the Assistance Board.

Examination plans and the examinations themselves change on the basis of information gained by monitoring institutions between annual examinations. FCA officials described the individual examination plans as well as field and regional office strategic plans as "dynamic" documents—i.e., they change as events and institution conditions change. Those officials told us the current numerical rating for an institution, the CAMEL rating, is the starting point for determining the extent of examination work in various areas. CAMEL is a rating system that assesses capital adequacy, asset quality, management, earnings, and liquidity management.

CAMEL Ratings Indicate Condition and Oversight Needed

Like other regulators of financial institutions, FCA examiners assign CAMEL ratings that reflect an institution's overall condition and the nature of regulatory oversight it needs. FCA adopted this rating system, a modified

[4]FCA sends bookletters (memos) to System institutions to explain selected regulations or provide other regulatory guidance. The other types of guidance are provided only to FCA staff.

version of that used by commercial bank regulators, in 1986. FCA modified the bank regulators' uniform rating system to provide for the cooperative and nondepository nature of the System institutions.

Component CAMEL ratings are determined primarily by the judgment of the examiner. Except for the rating given for management, examiners consider quantitative information in determining the component ratings. Overall, however, the assignment of ratings is a subjective process. The examiner recommends a composite CAMEL rating that the associate regional director must ultimately approve. We found that the FCA-assigned CAMEL ratings were consistent with the nature and extent of problems that examiners identified in the examinations we reviewed.

FCA's Examination Manual defines FCA-assigned CAMEL ratings and the level of oversight needed as follows:

- CAMEL 1 institutions are basically sound in every respect; any deficiencies are minor and can be corrected in the normal course of business. These institutions give no cause for regulatory concern.
- CAMEL 2 institutions are also fundamentally sound but reflect modest weaknesses, which are not material but could develop into greater concerns if they are not resolved. Regulatory response is limited to the extent that weaknesses are resolved.
- CAMEL 3 institutions have a combination of financial, management, operational, or compliance weaknesses ranging from unsatisfactory to moderately severe. They may be vulnerable to adverse business conditions when weaknesses relate to asset quality and/or financial condition and could easily deteriorate if problems are not corrected. More than normal supervision is required.
- CAMEL 4 institutions require close supervision and a definitive plan for correcting weaknesses. They have serious financial or operating weaknesses or unsafe and unsound conditions that are not being resolved. Unless corrective action is taken the conditions "are likely to develop into a situation that will impair future viability" or threaten the interests of investors, borrowers, and stockholders. The potential for failure is present but not imminent.
- CAMEL 5 institutions have high immediate or near-term probability of failure. Without decisive corrective action, such institutions will likely be liquidated or require some form of emergency assistance, merger, or acquisition.

The proportion of problem institutions has steadily declined since 1989 when 29 percent, including four FCBs with approximately 32 percent of System assets, were rated CAMEL 4 or 5. As of October 1992, 5 percent of the System institutions were problem rated. One of the banks that had approximately 8 percent of the System's assets was in this group.

Examiners Identified Key Deficiencies

Within the law's requirements and FCA's own practice of customizing examinations, examiners address key safety and soundness issues. These are capital, internal controls, audits, financial reporting, standards of conduct, lending, and investments. As table 2.1 shows, we found that FCA's examiners identified deficiencies in many of these areas. Deficiencies related to these issues have been associated with problem and failed banks, thrifts, and credit unions.[5] We considered these and other System-specific issues in reviewing examination reports and other documents to determine how FCA assesses safety and soundness and regulatory compliance. The System-specific issues we reviewed—loan pricing and compliance with borrower rights—were related to lending.

[5]Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 1989); Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 1989); Credit Unions: Reforms for Ensuring Future Soundness (GAO/GGD-91-85, July 1991; and Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/AFMD-91-69, Apr. 1991).

Table 2.1: Deficiencies Examiners Identified at Banks

	A			B		
Issues	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Capital						
Adequacy	x	x	x			
Calculation		x		x		
Internal controls	x	x	x	x	x	
Audits						
Internal	x	x	x		x	
External						
Financial reporting						
Shareholder reports		x	x	x		
Call reports	x	x			x	
Standards of conduct	x					
Lending						
Practices and credit administration	x	x	x	x		
Limits						
Insider					x	
Loan pricing	x					
Borrower rights						
Investments		x	x		x	

	Banks											
	C			D			E			F		
	1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
	x	x	x	x	x	x	x			x	x	x
	x			x	x		x	x	x			
	x	x	x	x	x	x	x	x	x	x	x	x
		x	x	x		x				x		x
	x	[a]	x		x							
	x	[a]			x			x	x	x		
	x		x	x						x		x
	x	x	x	x	x	x	x	x	x	x	x	x
					x		x					x
	x	x					x	x	x			x
	x	x	x		x	x	x	x	x	x	x	x
	[b]	x	x									x

Legend

x = Deficiencies

[a]Examiners did limited or no testing in these areas during the 1990 exam. However, financial reporting was reviewed in 1990 by an independent auditor as part of an FCA-required audit.

[b]Examiners did not assess compliance in this area in 1989 to focus on issues they believed more important to determining bank condition.

Source: FCA examination report data.

We reviewed examination reports from 1989 through 1991 and other documents from five FCBs and one bank for cooperatives. We updated our work through 1992 to learn the current condition of the banks. In 1992, banks we selected held assets totaling $36 billion, or 57 percent of the System's assets. Three of the banks were assisted and all were under enforcement actions at some time during the 1989 through 1992 period.

Capital: Examiners Usually Found It Inadequate for Risks and Found Errors in Calculation

FCA did not believe that the level of capital was adequate for the existing risks in all but one of the six banks we reviewed (see table 2.2), although all of the banks met the regulatory minimum level. Examiners also identified errors in the capital calculations of five of the banks. The 1987 act required FCA to establish a minimum capital standard for all System institutions to meet by 1993. FCA regulations set the minimum at 7 percent and provided for interim standards based on each institution's capital ratio as of June 30, 1988. The regulations emphasized that the final standard is a minimum level and not meant as the optimum level for any institution. All System banks met the minimum standard as of June 30, 1992.[6]

[6]The law does not permit FCA to acknowledge that the assistance preferred stock is, from the point of view of protecting the government's financial interest, a temporary form of capital. We will address this and related issues in a future report.

Table 2.2: Capital Deficiencies Examiners Identified at Banks

	A			B		
Issues	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Capital						
Adequacy	x	x				
Calculation		x		x		

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
x	x	x	x	x	x	x			x	x	x
x			x	x		x	x	x			

Legend

x = Deficiencies

Source: FCA examination report data.

According to FCA guidance, an examiner's objectives in reviewing an institution's capital are

- to evaluate the adequacy and the management of the capital to ensure safe and sound operations,
- to validate and verify the institution's computation of its permanent capital ratio, and
- to determine the institution's compliance with capital requirements and other related regulations.

Thus, reviewing capital has both subjective and objective elements.

Capital Found Inadequate Generally Because of Poor Asset Quality

Examiners reported that the level of capital was inadequate considering the existing risks at five of the six banks we reviewed. Although three of these banks were assisted, examiners believed the level of capital was inadequate even after assistance was provided. Most often, examiners cited poor asset quality as the reason. At one institution, examiners cited potential risk associated with off-balance sheet activities and potential liabilities related to environmental hazards at acquired properties as factors in determining asset quality.

In evaluating the adequacy of capital, examiners consider the quality of the assets, the quality and stability of earnings, the prospective growth of loan volume, and the ability of management to minimize losses under adverse financial conditions. Retained earnings are an institution's primary source for capital. Although institutions also acquire capital by borrower investments (stock borrowers are required to purchase to obtain a loan),

the amount of the stock is usually included in the amount of the loan.[7] That is, the loan is increased by the amount of stock purchased. Thus, this stock is not an equity investment in the usual sense of the term. It is essential, therefore, for System institutions to generate and retain adequate earnings.

FCA Found Errors in Capital Calculation

Computing the capital ratio, as specified by regulation, is complicated. System banks and associations invest in each other, and regulations require them to deduct reciprocal stock investments to prevent a double counting of capital.[8] Assets are risk-weighted as specified by regulations. In addition, regulatory capital standards for each institution varied from 1989 until January 1, 1993, because interim standards applied.

FCA examiners reviewed the capital computations of the banks and identified errors at five banks in eight examinations. FCA required the banks to make corrections. One bank made the same type of errors in 3 consecutive years. It failed to deduct stock owned in another System institution, did not assign assets to the right risk category, and made other mistakes. Examiners told management that the internal controls were not adequate to ensure accurate calculations and the process needed closer supervision. In addition, the process was not fully automated, and mistakes were made in manual calculations at this bank.

Internal Controls: Generally Criticized by FCA

FCA examiners identified internal control weaknesses at all six banks (see table 2.3) and considered the effect and/or potential effect of control deficiencies. In subsequent enforcement actions, FCA required the banks to correct control deficiencies. FCA's Examination Manual sets forth the principles of effective internal controls, states objectives in evaluating internal controls, and describes procedures examiners might follow. We

[7]Stock issued before 1988 is protected, that is, the borrower is guaranteed it will be redeemed at par or face value. Stock issued in 1988 or after is at risk of loss.

[8]In computing the permanent capital ratio until January 1, 1993, regulations permitted banks and their direct lender associations to agree on what percent, if any, of an association's equity in the bank could be counted in the association's capital base. If the institutions did not agree, the association's investment in the bank was allocated 20 percent to the bank and 80 percent to the association. Beginning in 1993 and through 1998, regulations specify how the equities banks distribute to associations will be allocated for computing capital. In 1993, 100 percent is allocated to associations and none to banks. Through 1998, the amount will decrease for associations and increase for banks until 1998, when 100 percent will be allocated to the banks.

In October 1992, Congress effectively made the transitional provisions of the existing regulations permanent (P.L. 102-522, Sec. 101). Therefore, banks and their associations will continue to determine whether and to what extent an association's investment in a bank is deducted from the association's capital when they compute their capital. Congress also provided the authority for banks to have individual agreements with each association, rather than a districtwide agreement.

reviewed the results of the examiners' evaluations of internal controls but not the procedures they used in doing this work.

Table 2.3: Internal Control Deficiencies Examiners Identified at Banks

Issue	A 1989	A 1990	A 1991	B 1989	B 1990	B 1991
Internal controls	x	x	x	x	x	

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
x	x	x	x	x	x	x	x	x	x	x	x

Legend

x = Deficiencies

Source: FCA examination report data.

The examiner's manual states the following three objectives for reviewing internal controls at System institutions:

- "To determine that the institution has established procedures and other controls that safeguard its assets, ensure the reliability of its financial disclosure to shareholders, promote efficient operations, and ensure compliance with established policies, laws, and regulations.
- To evaluate the effectiveness of the established procedures and other controls to prevent and detect errors, inefficiencies, and fraud.
- To obtain corrective action when deficiencies in established procedures and other controls are identified and violations of laws and regulations are noted."

Examiners identified deficiencies in credit, investments, wire transfers, internal audits, and funds management and required corrections. We discuss specific examples of such problems later in this chapter. Although some internal control weaknesses persist, FCA found that all of the banks made progress in strengthening internal controls over the 1989 through 1991 period.

In addition to their own evaluations, examiners considered two other sources of information on internal controls: internal audits and outside auditor reports. They reviewed the plans and audit work of banks' internal auditors and management's responses. Examiners reviewed the annual audit reports and any management letters issued by outside auditors. In addition, examiners periodically met with the outside auditors to discuss their work and findings.

A strong internal control system provides the framework for the accomplishment of management objectives, accurate financial reporting, and compliance with laws and regulations. Effective internal controls

serve as checks and balances against undesired actions and, as such, provide reasonable assurance that banks operate in a safe and sound manner. The lack of good internal controls puts the banks at risk of mismanagement, waste, fraud, and abuse.

FCA regulations, which took effect in June 1990, require each institution's board to adopt an internal control policy that provides adequate direction to its institution in establishing effective controls over and accountability for operations, programs, and resources. Adequate board oversight to ensure that the policies and procedures are followed is the cornerstone of effective internal controls. Examination reports emphasize the responsibility of boards of directors to see that adequate policies and procedures exist and are followed. Examiners identified internal control weaknesses related to credit administration, including lending activities, at all 6 banks in 17 of the 18 exams we reviewed. They identified weaknesses in controls related to financial reporting at five of the banks. These problems were often related to deficiencies in credit. For example, if the performance status of a loan is not properly identified, the allowance established for potential loan losses may not be adequate. Examiners found the policies and procedures for internal controls were deficient in some way at five of the banks. For example, some portions of the controls were out of date, did not clearly assign responsibility, or did not adequately address a particular issue.

The one bank examiners did not criticize for deficiencies in overall policies or procedures was cited for failure to follow up on correcting previously identified weaknesses. In the bank's 1989 examination, FCA identified about $20 million in loans that were nonaccrual but had been reported as accrual. Although bank management directed staff to make changes in the loan accounts in 1989, FCA examiners found in the 1990 examination that the changes had not been made. FCA examiners identified the internal control weakness that resulted in this problem: There was no follow-up by supervisory management.

FCA examiners identified control weaknesses related to investments, borrower rights, or management information systems at three banks. Examiners cited two other banks for specific control weaknesses in accounting, asset-liability management, and wire transfers. Failure to properly report suspected criminal activity, loan pricing, and other deficiencies were cited at individual banks. We provide details of some of the deficiencies later in this chapter.

In past work on bank and thrift regulators, we emphasized the importance of internal controls to safe and sound operations and noted that annual, comprehensive evaluations of internal controls are essential to these insured depository institutions. A strong internal control system is also important to System banks. However, as we discuss in chapter 1, although System banks are somewhat similar to other financial institutions, they are different because the System is a GSE and it does not comprise depository institutions. We believe it is appropriate for FCA's regulation to reflect this difference. Nevertheless, FCA should ensure that a comprehensive evaluation of internal controls is made within its customized, risk-based examinations. This is especially important because FCA now has authority to limit the scope of its examinations. FCA's guidance specifies that its evaluations of a bank's internal control system include the following elements:

- an overall understanding of the major operating functions within the institution, such as lending, and an assessment of risk within those functions;
- an assessment of the adequacy of the design of the control systems within each major operating function to determine if the systems are set up to effectively prevent undesirable activities;
- specific identification of critical control procedures within the systems, such as loan approval requirements;
- testing of critical control procedures to determine if they are operating as designed; and
- evaluation of the results of the control tests to determine if the control systems are effectively operating to prevent undesirable activities.

Audits: FCA Uses Audit Information If It Is Reliable

FCA's guidance makes it clear that examiners must evaluate internal audit programs, review the work of outside auditors, and use the work of both when they find it reliable. Examiners evaluated the internal audit work of all six banks we reviewed and found deficiencies, to varying degrees, in five of them (see table 2.4). FCA found that all of the banks improved their programs over the 3-year period we reviewed. All System institutions are to have their financial statements audited annually by a qualified public accountant. For all of the banks we reviewed, FCA found that an annual audit was done by an independent auditor. Banks submit the independent auditors' reports to FCA field offices, and examiners review them during routine monitoring.

Table 2.4: Audit Deficiencies Examiners Identified at Banks

	A			B		
Issues	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Audits						
Internal	x	x	x		x	
External						

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
	x	x	x		x				x		x

Legend

x = Deficiencies

Source: FCA examination report data.

FCA Found Most Internal Audit Programs Needed Improvements

Examiners harshly criticized the scope and adequacy of internal audit programs at two of the banks, criticized two other banks that were establishing programs between 1989 and 1991, and found minor deficiencies at a fifth bank. FCA found the deficiencies in three programs so serious that it required specific corrective actions to be done as part of its enforcement actions. Examiners did not rely on the banks' internal audit work during this time. In contrast, they relied on the internal audit work of two other banks. FCA found no deficiencies in one and minimal deficiencies in the other over the 3-year period. By 1992, four of the five banks that FCA examiners criticized had substantially resolved the deficiencies to FCA's satisfaction.

Examiners Reviewed External Audit Reports and Monitored Bank Response to Management Letters

We found that FCA examiners checked that the banks had received an annual external audit. All of the banks we reviewed had such an audit. FCA examiners use outside auditors' work and periodically meet with them to discuss the condition of the banks. Outside auditors issued management letters to four of the banks, and FCA examiners reviewed those letters as part of the monitoring process. Management letters identify deficiencies in internal controls and accounting operations and recommend improvements. Two of the letters cited problems with loan classification, loan file documentation, and credit administration deficiencies. FCA identified similar problems in its examinations of the same two banks. Letters to the other two banks focused on accounting problems related to restructured loans. Again, FCA examiners had also brought these problems to management's attention. In these instances, the work of FCA and the outside auditors complemented one another. It was evident to us in reviewing examiners' workpapers that they monitored the banks' responses to the outside auditors' letters.

Financial Reporting: Examiners Required Corrections

Regulations require System institutions to disclose financial and other relevant information to shareholders quarterly and annually. System institutions also submit a quarterly report of condition and performance, known as a call report, to FCA. FCA examined both institutions' reports to shareholders and call reports of the six banks we reviewed, identified weaknesses in the reports, required banks to make corrections, and assessed their compliance.

FCA's guidance for reviewing institution disclosure and call reports appears sufficiently comprehensive and specific. FCA regulations on disclosure to shareholders define the required disclosure information and the distribution of reports. FCA's Examination Manual includes pro forma workpapers for reviewing disclosure documents and call reports. The manual suggests that examination testing could be minimal or omitted if prior examinations had not uncovered any significant problems.

Examiners usually used the workpapers provided in the manual to evaluate the adequacy of an institution's public disclosure. Because these workpapers are summations of regulatory requirements, FCA has a sound foundation for criticizing an institution.

Reports to Shareholders Were Routinely Examined for Accuracy

FCA found few deficiencies in our sample banks' reports to shareholders. In all, FCA cited 4 of the banks for deficiencies in 6 of 18 examinations (see table 2.5). For example, FCA cited one bank for weaknesses in 2 of the 3 years reviewed, 1989 and 1991. In its 1989 examination, FCA noted significant concerns about the general accuracy of financial statements produced by the bank. Because of reporting and other weaknesses, the bank was placed under an enforcement action. In one article of the enforcement action, FCA addressed the questionable reliability of the bank's accounting and credit statements, which affected its reporting. FCA required an interim audit that resulted in adjustments to the 1989 financial statements. In the 1990 and 1991 examinations, FCA stated that the bank was in full or substantial compliance with this enforcement action article. In the 1991 examination, FCA did note some minor deficiencies and omissions in the annual report but nothing that materially affected the information in the report.

Table 2.5: Financial Reporting Deficiencies Examiners Identified at Banks

	A			B		
Issues	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Financial reporting						
Shareholder reports		x	x	x		
Call reports	x	x			x	

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
x	[a]	x		x							
x	[a]			x			x	x	x		

Legend

x = Deficiencies

[a]Examiners did limited or no testing in these areas during the 1990 exam. However, financial reporting was reviewed in 1990 by an independent auditor as part of an FCA-required audit.

Source: FCA examination report data.

Call Reports Were Checked, and FCA Emphasized the Need for Accuracy

The call report deficiencies that examiners cited most were related to high-risk and nonperforming assets. For the 3 years reviewed, three of the banks in 1989, four in 1990, and one in 1991 had deficiencies (see table 2.5). In 1989, one of the banks inaccurately reported high-risk assets, nonperforming assets, and excess collateral and overstated acquired properties and notes payable. These errors misrepresented the condition of the bank. They occurred because bank officials failed to verify information compiled from different sources within the bank. FCA required corrections and emphasized that the bank needed to have policies and procedures to ensure that the call reports were verified in the future.

The 1990 examination again noted that the bank's call reports were inaccurate. Examiners again said the reason for inaccuracies was the bank's lack of established reporting requirements and internal control weaknesses. FCA took enforcement action against this bank in 1990 and, among other things, required it to correct and refile its last quarter's call report and disclose in the next quarterly statement to shareholders the previous understatement of high-risk assets. The bank complied with the action, and examiners did not find any deficiencies in call report accuracy or disclosure to shareholders in 1991. Examiners continued to be diligent in their oversight of call report accuracy in 1992 and found an inaccuracy related to investments. They required the bank to file a corrected report.

Standards of Conduct: Examiners Were Alert to Conflicts of Interest and Found Few Problems

FCA annual examinations include conflict-of-interest reviews. In 6 of 18 examinations, examiners reported some conduct-related problem at 4 of the banks and required the banks to resolve them (see table 2.6). FCA regulations provide adequate safeguards that if followed by System institutions, should prevent conflicts of interest and provide adequate oversight by appropriate bank officials. Conflict-of-interest problems contributed to the amount of losses sustained by failed commercial banks and savings and loan institutions.[9]

[9] Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991) and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Table 2.6: Deficiencies in the Standards of Conduct Examiners Identified at Banks

	A			B		
Issue	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Standards of conduct	x					

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
x		x	x						x		x

Legend

x = Deficiencies

Source: FCA examination report data.

FCA regulations defining standards of conduct for directors and employees are broad, warning them to avoid real or apparent conflict and requiring disclosure of their business affiliations. These regulations require each bank to have a standards of conduct officer, issue policies and procedures, and ensure that its employees and directors—including those of the associations it supervises—comply.[10] Like other financial institution regulators, FCA emphasizes directors' responsibilities in a handbook it provides to all board directors. The handbook states that a director "must be fair in dealing with the institution, must refrain from even the appearance of conflicts of interest and always act honestly and in good faith." It further notes that directors are prohibited from using influence or knowledge gained from their positions for personal gain or the gain of others. In our opinion, providing guidance on the role and responsibilities of directors is especially important in the cooperative Farm Credit System where board members are primarily farmers, not financial experts. However, in October 1992, FCA announced it would no longer produce the handbook because of budget constraints.

FCA requires its examiners to determine whether a bank appropriately addresses and resolves any conflicts of interest. It recommends reviewing policy, procedures, and the related internal controls; disclosure reports; minutes of board meetings; and the status of previously reported conflicts of interest. FCA emphasizes that no particular procedures will always identify conflicts of interest and directs examiners to be constantly alert for such problems.

[10]The Farm Credit Banks and Associations Safety and Soundness Act of 1992 required FCA to review current regulations regarding the reporting of potential conflicts of interest and financial disclosure. FCA was to determine whether the regulations were adequate (1) to ensure safety and soundness and (2) to provide System investors and stockholders with sufficient information for making decisions about investments and operations of System institutions. FCA completed this review and proposed amendments to its standards of conduct regulations at the July 15, 1993, FCA board meeting.

Virtually all examination workpapers and/or monitoring files we reviewed showed that examiners had followed FCA guidance in testing for compliance with standards of conduct. Most often examiners cited the need for procedural improvements, but they identified problems of a more serious nature in three of the six examinations.

Examiners cited one of the banks in 1989 for improperly handling a conflict of interest concerning a bank officer who owned a consulting firm that did System-related business. Although bank officials had spoken with the bank officer about the potential for problems, the bank had no records of the meetings and had not provided the bank officer with reporting requirements. FCA required the bank to make a plan to deal with these deficiencies and identify specific corrective actions.

FCA advised another bank in 1989 that permitting the chief executive officer of the bank to serve as the secretary of the board presented a potential conflict of interest. Saying that this situation could create problems due to a lack of separation of duties, FCA required a change in this arrangement as part of an enforcement action.

In 1991, FCA criticized a standards of conduct officer for failing to follow up on conflicts of interest FCA examiners had identified at several associations in a district. FCA's 1992 examination showed that the bank made improvements.

Lending: Examiners Identified Many Deficiencies

An examiner's review of lending includes assessing an institution's policies and procedures and its compliance with laws and regulations along with detailed reviews of selected loans. FCA examiners identified varying levels of deficiencies at all six banks (see table 2.7). In the following sections, we review the examiners' assessments of deficiencies in lending practices and credit administration, compliance with lending limits, insider lending, loan pricing, and borrower rights requirements.

Table 2.7: Lending Deficiencies Examiners Identified at Banks

	A			B		
Issues	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Lending						
Practices and credit administration	x	x	x	x		
Limits						
Insider					x	
Loan pricing	x					
Borrower rights						

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
x	x	x	x	x	x	x	x	x	x	x	x
				x		x					x
x	x					x	x	x			x
x	x	x		x	x	x	x	x	x	x	x

Legend

x = Deficiencies

Source: FCA examination report data.

The sample of loans examiners review is important because findings on other issues are partly based on its results. For example, an examiner considers the loan performance and risk of loan portfolio in determining if capital is adequate. Also, corrections to call reports often result from the reclassification of loans. Because most bank assets are in loans, the quality of the examiner's assessment of a bank's deficiencies depends heavily on the quality of the review of its loan portfolio.

We studied FCA's loan portfolio review guidance and obtained detailed information on the examiners' reviews of portfolios in 1991 at the six System banks. Examiners stratified the loan portfolios and judgmentally selected loans to review. In loan categories they judged to be high risk (such as direct and participation loans), they reviewed loans representing large dollar amounts within the category. Because the examiners reviewed a large proportion of the dollar amounts within those high-risk categories, the samples appear to have been acceptable, and any error in the unreviewed portion of the high-risk categories of the portfolio would have been immaterial. We believe reviews of these high-risk categories were adequate.

FCA believes the long-term mortgage loans are not high risk, and examiners, therefore, reviewed small portions of this category of each bank's portfolio. Examiners also judgmentally selected the mortgage loans they reviewed, and therefore, their samples were not representative of the mortgage portfolio. However, there were extenuating circumstances

relating to the reviews at each bank. For example, an outside auditor had done an extensive review of one bank's loan portfolio in the preceding year. We believe it can be appropriate for examiners to consider such conditions in deciding the extent of their own reviews if they have properly evaluated the work of the outside auditors or others. We suggest, however, that examiners randomly, rather than judgmentally, select samples when reviewing small portions of a portfolio. Random sampling would not mean looking at more loans. It would mean selecting loans in an unbiased manner. This approach would give FCA greater confidence in the results of these small mortgage loan samples. We provide more information on FCA's loan portfolio reviews in appendix I.

Examiners Found Weak Lending and Credit Administration Practices

Examiners identified lending or credit weaknesses at all six of the banks (see table 2.7). However, the variance in deficiencies was significant. Examiners found numerous and serious deficiencies at three of the banks, a few at two banks, and a minor problem at the sixth bank. The extent of the deficiencies reported was consistent with the FCA-assigned CAMEL ratings. The most frequently cited deficiencies were inadequate credit analysis and controls and servicing of the loans. Examiners criticized the policies and procedures at 4 of these banks in 9 of their 12 examinations and noted in 7 of 12 examinations that information was not always adequately verified at these banks.

FCA guidance for reviewing credit operations highlights these areas related to overall lending: policies and procedures, credit philosophy, delegated authority, loans to one borrower, loan committees, internal credit reviews, loan file organization, credit trends, and external conditions. When assessing credit administration (defined as all the procedures a lender must follow in making, servicing, and collecting loans), examiners must consider the adequacy of information gathered, verification and analysis of the information, loan documentation, controls, and servicing of loans.

FCA's guidance addressed the safety and soundness of lending practices and credit administration. Examiners' reviews of these issues appeared to be thorough, and they documented the problems identified. FCA required appropriate corrective actions, and as we discuss in the next chapter, the five banks with the most severe problems resolved or made progress in resolving the deficiencies.

Adequate analysis of credit information must address what FCA guidance refers to as the five "Cs" of credit: character of the borrower, capital, capacity to repay, conditions, and collateral. Analytical deficiencies that

examiners usually cited were inadequate or outdated financial information on the borrower and inadequate evaluation of collateral or the borrower's repayment capacity. FCA described significant problems in this area for one bank, noting that faulty risk analysis can, along with other deficiencies, contribute to significant losses during periods of stress in the agricultural economy.

The analysis of repayment projections based on incomplete or outdated information was the most frequently cited weakness at one of the banks. For example, examiners said bank officials failed to consider the financial effect of real estate purchases on some borrowers. In other instances, the bank failed to analyze historical data adequately in evaluating projected increases in production to support the repayment of a loan.

FCA noted weakness in another bank's analysis of credit factors and cited the need for better policies and procedures in this area. Examiners not only identified the deficiencies in specific loans but identified the underlying causes—inadequate policies and procedures—and called on the bank to correct both problems.

Five of the banks were criticized for inadequate or deficient controls over and servicing of loans. Inadequate servicing of large troubled loans adversely affects an institution's ability to control its risk. Some specific deficiencies FCA cited were a lack of timeliness of loan servicing and weaknesses in service plans on high-risk assets. Another deficiency frequently cited was a bank's failure to correct loan problems and to prevent recurrences of the same problems at associations. For example, examiners found that one bank's loan review program identified problems in the loan closing practices at some associations. The bank did not take adequate action to prevent recurrence of the problems. Examiners criticized another institution in all 3 years for loan servicing plans that did not include sufficient actions to correct or reduce risk because of weaknesses in credit factors.

Examiners evaluate both the appropriateness and the implementation of lending and credit administration policies and procedures. FCA cited one of the banks for policy and procedure deficiencies in all 3 years. In 1989, the examination report cited deficiencies in the bank's implementing its board policy on high-risk asset accounting. The bank inappropriately reversed charge-offs, which are reductions in the value of a loan resulting from the recognition of a loss. This deficiency caused errors in the bank's financial accounts and its public reports on financial condition. FCA cited this same

bank for numerous deficiencies in originating, processing, and servicing loans. By 1991, the bank no longer originated loans, and its association had updated and refined policies and procedures. However, FCA found the bank did not have adequate controls to ensure the policies and procedures were being followed.

Examiners criticized another of the banks in 1989 and 1991 for weaknesses in its guidance for identifying loan performance status. The inaccurate performance classifications resulted in understating risk and overstating bank income. The bank's error rate on loan classifications was 10 percent in 1991. The 1991 examination cited the bank for not ensuring that associations had reliable controls and reporting mechanisms for sound credit administration and risk identification. These continuing administrative deficiencies in the associations' policies and procedures caused inaccuracies.

Weaknesses examiners identified in the verification of information involved assessment of collateral, the borrower's current financial condition, credit references, title to property, and other issues. Examiners identified credit administration deficiencies in 24 percent of the loans reviewed at one of the banks. For example, in 1991 they noted that a real estate appraisal had not been updated since 1987 and the borrower's financial condition had not been analyzed since late 1988.

Lending Limits to Borrowers Were Not Violated; New Regulations Will Reduce High Limits for Most System Institutions

Examiners did not identify any violations of the regulations limiting the amount banks can loan borrowers. (See table 2.7.) In 1989, they cited one bank for weaknesses in procedures that created the potential for lending limit violations. Concentrations of loans result in insufficient portfolio diversification and have been associated with problems at other financial institutions.[11]

FCA regulations in effect until December 31, 1993, limit an FCB's extensions of credit to one borrower at 20 percent of capital and surplus. The limit for associations is 50 percent of capital and surplus, or 100 percent if a loss-sharing agreement is in place.[12] In January 1991 FCA proposed changing the regulations to limit lending for FCBs and associations to 20 percent of capital. FCA said the revisions were needed to accommodate

[11]See Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991), p. 25; Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991), p. 9; and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989), p. 32.

[12]These are agreements made among institutions in districts to share each others' losses. See discussion in chapter 5.

structural changes in the System and to promote safety and soundness. Some System officials objected to the tighter limits, and FCA did additional analyses to study the effect of its proposed changes. Our draft report, issued for review and comment to FCA, FCSIC, and the System on July 13, 1993, recommended that FCA adopt its proposed 20-percent lending limit for FCBs and associations. On July 28, 1993, FCA published final regulations, effective January 1, 1994, that limit lending for FCBs and associations to 25 percent of permanent capital as defined in the regulation.

The new regulatory limit will bring FCB and association lending limits more in line with the limits of other financial institution lenders. National banks and savings and loans are generally limited to loaning up to 15 percent of unimpaired capital and surplus to one borrower and another 10 percent on fully secured loans.

The new regulations contain other changes that we believe will enhance System safety and soundness and promote efficiency in FCA's oversight. For example, the computation of total loans to each borrower will now include the total amount of undisbursed commitments as well as the total unpaid principal of loans. A number of FCA's prior approvals were eliminated, and the rules for attributing indebtedness to a borrower were expanded and clarified with specific criteria.

The lending limits for banks for cooperatives differ from those of other System institutions. Banks for cooperatives have a limit of 25 percent of permanent capital for term loans to cooperatives. Other types of credit—term loans to others, standby letters of credit, guarantees, seasonal loans, foreign trade receivables, bankers acceptances, and export and import letters of credit—are limited in varying percentages of capital. For example, seasonal debt is limited to 35 percent of capital. However, the sum of all such credits for any one borrower may not exceed 50 percent of permanent capital. The 1987 act prohibits FCA from setting limits for CoBank that would be more restrictive than the combined limits previously set by regulation for district banks for cooperatives and the former Central Bank for Cooperatives. Thus, FCA did not propose any change to the lending limits for CoBank. Although the law applies only to CoBank, an FCA official told us FCA has not lowered the limits of the other two cooperative banks because having lending limits lower than CoBank's would put them at a disadvantage.

FCA is concerned about the dangers concentrated lending poses at banks for cooperatives and wants authority to adjust the limit should it

determine changes are needed. In its Legislative Recommendations 1991, FCA recommended that Congress repeal the statutory prohibition against lowering the lending limits for CoBank below the level established by FCA regulation in 1987. FCA included one example in which the high limits threatened the viability of one bank for cooperatives. Before the merger creating CoBank, FCA reported one bank for cooperatives had losses on loans to one borrower that exceeded 35 percent of its net worth. In our draft report, we concurred with FCA that concentrations of loans made to one borrower by cooperative banks can pose problems. We recommended that Congress give FCA the authority to set appropriate limits for CoBank.

In their responses to our draft report, FCA concurred with our recommendation, and CoBank objected to it. In follow-up discussions, FCA officials emphasized that the FCA board would not necessarily lower the CoBank lending limits at this time if it had the authority. FCA prefers, however, not to be prohibited from doing so should such action be warranted. A study FCA completed after our draft report was released does not indicate that CoBank's current lending activity poses any undue threat to its safety and soundness.

In September 1993, FCA's OE completed a review of the regulatory lending limits that are applicable to CoBank. The report to the FCA board stated that "with the system of internal controls presently employed, the CoBank Board of Directors has established sufficient mechanisms to ensure lending operations control risk and preserve the stability of bank earnings." Further, the FCA report stated that CoBank's own internal lending limits have maintained reasonably effective controls over the amounts outstanding on large loans. The FCA report noted, however, that as of June 1993 CoBank's two largest loans would reach the regulatory lending limits if commitments were included with the outstanding balances, which the new regulation requires beginning January 1, 1994. OE staff noted that examiners will monitor these and other large loans closely.

CoBank's response to our recommendation emphasized that (1) it has successful policies in place to restrict and monitor concentrations of credit, (2) FCA has never cited it for violations, and (3) its historical record of loan losses is good compared to other lending institutions. (See the full text of CoBank's response in app. VII.) FCA's recent study indicates that CoBank's policies appear to be adequate. CoBank noted that its own internal lending limits are lower than the regulatory limits. This seems to imply that CoBank generally does not need or want to risk making loans as large as the regulations now permit. We are aware that FCA has never cited

CoBank for a violation of lending limits. Although CoBank's record of past loan losses appears to be good (we did not validate the data CoBank submitted), we note that historical data are not always a reliable predictor of future performance. This point is especially relevant with the expansion of CoBank's lending authority to new areas, such as rural water and waste water disposal systems.

We still believe it is inadvisable for FCA to be restricted from changing CoBank's lending limits should it determine this is appropriate. FCA has this regulatory power over all other System institutions. We recognize that FCA is not without means to address any unsafe lending. FCA is still able to use its enforcement authority to curb any unsafe or unsound lending practices. Although taking such actions could result in delays or litigation, we note that FCA has taken timely and strong enforcement actions in the past. (Ch. 3 addresses FCA's enforcement activities.) Having authority to change CoBank's lending limits if needed would enable FCA to forestall any potentially serious problems.

FCA Found Few Insider Lending Problems

Examiners reviewed loans to insiders held by the banks as part of the annual examination. They found few problems and required the banks to resolve those that were identified (see table 2.7). Guidance to examiners appears to be comprehensive. It includes pro forma workpapers to document the adequacy of disclosure of insider loan transactions.

Insider loan problems have contributed to commercial bank and savings and loan failures.[13] The managers and board members of these institutions made transactions that were not in their institutions' best interests but that benefited the directors, officers, and other related parties. While such violations do not always cause an institution's failure, they can contribute to losses.

FCA guidance requires examiners to review all insider loans to determine that they comply with regulations. It defines insiders as directors, officers, and employees of any System institution or a family member, an agent, or an entity constituting a business relationship controlled by any of those people. Regulations require a bank's board to approve any loan to the president of an FCB or any FCA employee. Boards may delegate approval authority to management for loans to

- a member of the FCA board or bank board and

[13]Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991) and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

- a cooperative when a bank board member is also a member of its board.

If approval authority is delegated, the loans must be submitted to the board for later review. Regulations also require prior bank approval of loans that associations make to insiders that exceed a ceiling set by the bank and approved by FCA.

In 4 of the 18 bank examination reports we reviewed, examiners cited problems related to the quality and monitoring of insider loans. In one case, FCA downgraded the classification of a loan from an acceptable to an adverse category. In another instance, FCA criticized a bank for not requiring plans from directors for upgrading their adversely classified loans. The bank was setting up controls to address this deficiency. Eleven percent of the insider loans held by this bank were adversely classified.

By 1991, some of the six banks we reviewed had few insider loans on their books because they were becoming wholesale lenders and making fewer loans directly to farmers. FCA examiners did not review insider loans at one bank in 1991 because the loans were not adversely classified and had been reviewed previously. FCA's reviews of insider loans and the banks' oversight of association compliance will become increasingly important with future changes in bank operations.

Loan Pricing Deficiencies Identified

As required, FCA regularly reviews bank loan pricing programs. The programs specify the types of retail loans (e.g., fixed rate or adjustable) associations can make to farmers, ranges for interest rates, and other parameters. System banks also have guidelines for pricing their wholesale loans—loans to associations, which are also called direct loans. The FCA examiners' guidance discusses analytical methods and explains the significance of loan pricing to an institution's soundness and viability. Examiners used the guidance in the examinations we reviewed. In the examinations for our six sample banks, FCA did not report any instances of what it defines as predatory pricing.[14] However, examiners criticized both wholesale and retail pricing at two of the banks and the management of the loan pricing process as it relates to matching assets and liabilities at two of the others.

[14]We reviewed all complaints of predatory pricing FCA received from 1989 through 1991 and determined FCA investigated and responded appropriately. FCA did not find that any System institution had acted improperly in making or pricing any of the loans referred to in these complaints. FCA took enforcement action in 1990 against one association in the West because, on the basis of the 1989 and 1990 examinations, FCA believed it was engaging in predatory pricing. Loan pricing in the System, and by other providers of agricultural credit, will be discussed in detail in a future GAO report.

The Farm Credit Act of 1971, as amended by the Farm Credit Act Amendment of 1986 (P.L. 99-509, 100 Stat. 1877), states that the purpose of the System is to provide "equitable and competitive interest rates to eligible borrowers." FCA must ensure that System institutions have and follow appropriate loan pricing programs. FCA regulations on interest rates and charges define profitability criteria for the institutions. This group of regulations requires institutions to set interest rate plans that contain loan pricing policies and guidance on adjusting these rates. The regulations also describe the types of interest rate programs to use and rules on discounts and past-due loans.

Effective loan pricing programs can enable an institution to sustain its maximum profitability and ensure its long-range viability. This second aspect of loan pricing is important to an institution's asset-liability management, specifically in managing interest rate risk.[15]

FCA guidance describes preexamination analyses examiners can use to identify potential problems in loan pricing programs as well as other areas of earnings. It notes key deficiencies, such as the failure to price loans to cover all expenses and ensure continuing operations. The guidance describes components of an effective loan pricing program, such as internal review, and controls to ensure compliance with board policy on loan pricing.

Examiners always did extensive reviews and evaluations of loan pricing using these criteria at our sample banks. They criticized four of the six banks for deficiencies at some time during the 1989 through 1991 period.[16] (See table 2.7.) They cited two of the banks for problems related to pricing retail and wholesale loans and two for asset-liability problems. Examination workpapers and reports noted whether the banks' pricing programs were adequate to help ensure that earnings would cover costs and contribute to capital. One of the banks was criticized in all three examinations; another was criticized in 1989 and 1990. The two banks with asset-liability problems were criticized in 1 year out of the 3. All but one made improvements by 1992.

[15]Interest rate risk can occur when loan pricing policy and interest rate programs do not consider the quality and quantity of earnings and when management prices loans below the cost of funds. Asset-liability management is the practice of managing an institution's entire balance sheet and off-balance-sheet structure and income statement to maximize earnings goals while maintaining an acceptable level of risk. It is essentially the process of planning the asset-liability mix to earn profits by keeping the widest spread possible between the interest earned and the cost of funds while minimizing or controlling interest rate and liquidity risk.

[16]In addition, as part of another audit, we reviewed FCA examiner workpapers and findings on loan pricing for all System banks in 1991. We found their analyses appropriate and comprehensive.

In 1989, examiners cited one of the banks for not using all available strategies to retain loan volume and maximize profits within competitive limits in its long-term portfolio. The bank was not differentiating retail loan interest rates on the basis of loan size or other factors but was using the same interest rates districtwide.[17] In addition, the bank was not adequately incorporating all appropriate risk factors. Examiners also criticized the bank's philosophy of pricing association, or wholesale, loans at lower than normal rates. This pricing lowered profitability in this portfolio segment. In 1990, examiners noted improvements in pricing retail loans; the bank was considering credit risk, loan size, geographic location, and other factors in making new loans. The bank, however, had not ensured the repricing of the previously incorrectly priced loans and still was not adequately considering risk in pricing its wholesale loans. By 1991, FCA found problems with wholesale loan pricing only. Examiners reported the bank was pricing wholesale loans on the basis of outdated risk evaluations that did not incorporate other available credit risk analysis that was more timely, thus more reliable.

Examiners criticized one of the banks for not adequately identifying or developing strategies to minimize the risk associated with a change in loan products. Its board policies and application of an asset-liability management program were flawed. The bank had increased adjustable rate loan products, which created new interest rate risk exposures. The repricing of the variable rate loans was based on an index different from the bank's cost of funds. Any adverse shifts in these indexes would sharply reduce the bank's returns.

A Significant Focus of Examinations Is Checking Compliance With Borrower Rights Requirements

FCA has responded to borrower rights requirements in the 1987 act. FCA requires an assessment of an institution's implementation of borrower rights programs for distressed loans and compliance with associated statutes and regulations in every examination. In our review of examination reports, we found that borrower rights were routinely examined and any deficiencies were noted. The deficiencies identified at four of the six banks (see table 2.7) generally appeared minor, and examination reports or enforcement actions were used to describe corrections to achieve compliance. (We also discussed FCA's monitoring of borrower rights in ch. 4.)

[17]FCA regulations (12 C.F.R. 614.4321d) provide that differential interest rates may be established for loans based on type, purpose, amount, quality, funding, or operating costs; any combination of these factors; or such other factors approved by FCA. Differential interest rate programs should achieve equitable rate treatment among categories of borrowers.

Investments: Few Problems Identified

Most System institutions' assets—approximately 80 percent—are in loans, but the FCA regulations permit investment to maintain liquidity and to manage short-term surplus funds. However, investments cannot be used primarily for generating additional income. System institutions may hold obligations of the United States or certain of its agencies; high-quality, specific, short- to medium-term (i.e., will mature within 10 years) financial instruments; and other types of investments authorized by FCA. System banks supervise associations' investment activities. Banks for cooperatives can invest in foreign business entities to facilitate other types of transactions.

FCA guidance to examiners emphasizes the two restrictions specified in the regulations: Investments are for liquidity and cash flow purposes and must be of the highest quality. FCA maintains that in granting the System access to the capital market, Congress did not intend for System institutions to accumulate funds primarily for investment but for making loans to qualified borrowers. From FCA's perspective, investments should be held for liquidity and short-term funds management; therefore, they should be readily convertible to cash by sale or by maturity.

FCA examiners review and test a System institution's investment policies, practices, and procedures to determine if they are adequate and being followed. They judge the overall quality of the investment portfolio and its compliance with laws and regulations. FCA's guidance is comprehensive and should enable examiners to render appropriate opinions. Examiners reviewed investment activities at the six banks we studied and raised concerns about investment programs at four banks (see table 2.8). Two of the four banks had programmatic problems that required administrative or operational corrections. At the other two banks, FCA questioned their having funds invested above the level required for liquidity.

Table 2.8: Investment Deficiencies Examiners Identified at Banks

	A			B		
Issue	**1989**	**1990**	**1991**	**1989**	**1990**	**1991**
Investments		x	x		x	

Banks											
C			D			E			F		
1989	1990	1991	1989	1990	1991	1989	1990	1991	1989	1990	1991
[a]	x	x									x

Legend

x = Deficiencies

[a]Examiners did not assess compliance in this year in order to focus on issues they believed more important to determining bank condition.

Source: FCA examination report data.

One of the banks needed formal procedures, limits to authority, and better controls over its investment activities, according to FCA's 1990 examination report. Specific authorities and limits were not delegated below the level of the chief financial officer. However, a lower level officer made most of the investment decisions, completed management reports, reconciled accounting reports, bought investments, and directed custodial transactions. FCA specifically required the bank to address these problems in a 1990 enforcement action. In the 1991 examination, examiners found the bank had not corrected the deficiencies. By the 1992 examination, however, it had.

FCA examiners criticized another bank for holding large amounts of long-term, mortgage-backed securities whose values fluctuated. From the 1989 to the 1990 examination, the weighted average maturity of the investment portfolio increased from 0.3 years to 20.1 years. Examiners said the maturities were inconsistent with the bank's liquidity needs and that the long-term investments were not being used for liquidity purposes in violation of regulations. Examiners criticized the bank's board of directors for not maintaining adequate control over investment activities. FCA issued an enforcement action requiring this bank to, among other things, sell the securities in question and revise its investment and liquidity policies.

FCA criticized two of the banks for having more funds invested than was necessary for liquidity. One bank's officials disagreed with FCA saying that they wanted to ensure they would have sufficient funds should System institutions' access to the capital markets be interrupted. Officials at the other bank said they wanted their balance sheet to look stronger by showing more liquidity. System banks, through the Funding Corporation,

have set minimum liquidity standards under which they are to maintain a reserve that is sufficient to fund their operations for approximately 15 days.[18] On average, according to FCA, banks exceed the System-set standards by about 50 percent. FCA has no regulation defining adequate liquidity.[19]

Examination Quality Generally Consistent Over Time and Among Field Offices

Appropriate and effective quality controls are vital given the diversity in the System and FCA's customized oversight. The essential components of FCA's quality assurance efforts are

- headquarters requirements for quality controls,
- supplemental regional and field office guidance,
- peer reviews of field operations, and
- audits by the OIG.

FCA standards for quality controls, such as supervisory review of examination workpapers, are appropriate, and we found examination work generally met the standards. The quality assurance reviews at the field, regional, and headquarters levels seemed complementary, and their findings did not conflict with our own assessments.

To assess FCA's quality assurance efforts, we reviewed records in four field offices and interviewed staff representing five field offices and two regional offices. In addition, we compared what we found in reviewing examination reports and other documents used in the monitoring and enforcement processes with FCA's own quality standards. We studied FCA's 1992 peer reviews and selected OIG reports.

Appropriate Standards Set and Followed

FCA guidance prescribes appropriate standards for a quality assurance program at the headquarters, regional, and field office levels. On the basis of our review of examination reports, supporting workpapers, and

[18] The standards require banks to maintain a liquidity reserve to fund 50 percent of the principal amount of bonds and interest due within 90 days divided by 3, plus 50 percent of the principal amount of discount notes due within 30 days.

[19] FCA proposed changes to investment regulations in December 1991 but had not made them final as of April 1993. The proposed changes would limit the total amount of a bank's investment portfolio to 20 percent of its outstanding loans. Investments could be held solely for liquidity, managing short-term cash flow needs, and reducing interest rate risk. FCA proposed to incorporate the System's formula for a minimum liquidity requirement in regulations and to expand the list of eligible investments. System institutions objected to the 20-percent limit and the limit on investments for purposes of liquidity. Among other reasons, they note that other GSEs have no such restrictions. FCA continues to study these issues.

monitoring procedures, we did not identify any significant deficiencies in the field offices' applications of FCA's quality assurance principles.

FCA guidance prescribes several activities that, if properly carried out,[20] should enable the regional and field offices "to provide reasonable assurance that FCA's examination activities and programs comply with stated agency objectives and standards." The directive requires that

- associate regional directors (i.e., the head of each field office) be accountable for all field office products;
- examination planning be directly related to strategic work plans;
- all examination-related work be adequately supervised;
- workpapers be complete, referenced, and adequately reviewed; and
- staff be independent, objective, and follow all agency guidance.

We found that FCA field and regional office guidance covered virtually all elements of quality assurance defined in FCA guidance. Regional office guidance tended to be broad in nature, while field office guidance was more specific about carrying out quality controls. For example, one regional directive on quality control discussed supervision on exam work, among other topics; it required examiners-in-charge to review and sign workpapers. A field office directive included more specific requirements, including requiring reviews of selected workpapers by higher level examination managers.

We found the field offices' quality assurance and control procedures are part of their ongoing work—they are integrated into the monitoring, planning, and examination functions. Examination workpapers were generally well organized and indexed to examination summaries and final reports. The examination reports were consistent with information in the supporting workpapers; information had been verified, and supervisors had reviewed the work. In discussing how quality work is ensured, most associate regional directors emphasized the examination report approval process, including their own reviews of examination reports. These associate regional directors review most of the examination reports and rely on examination managers to visit examination sites and report on work in progress.

[20]"Quality Assurance Policy," FCA Office of Examination, Directive Number 9 (McLean, VA: 1989).

Peer Reviews Provide Useful Quality Checks, and Findings Were Consistent With Our Own

FCA has done internal peer reviews of its field operations since 1987 using ad hoc groups of examiners. These reviews are not required, however. Initially, the reviews assessed administrative as well as examination-related areas. The reviews evolved to focus only on examination and monitoring work and are now known as the Quality Assurance Review Program. The program provides reports on each region and field office to the Chief Examiner's Office. To assess this program, we analyzed the new 1991 guidelines for the reviews, the three 1992 regional peer review reports, and field and regional office directors' responses to the reports and talked with officials in charge of the program. The general findings of the 1992 peer reviews were consistent with the observations we discuss later in this chapter on the quality of examinations and monitoring at the four field offices we visited.

FCA's 1991 guidelines require the peer reviews to address issues important to the quality of FCA's examinations process: examination planning, scope adequacy, thoroughness of workpapers, problem detection through monitoring, quality control, the integrity of examination reports, and the resulting FCA-assigned CAMEL ratings. They also appear to be adequate to ensure consistency among reviews conducted by different teams of examiners. Regional and field office directors promptly responded to the findings and recommendations of the reviews. If properly carried out, their plans for procedural changes or closer adherence to established procedures should resolve the deficiencies.

Each review team (two or three commissioned examiners led by an examination manager) typically reviews the examination reports, workpapers, and related documents for a sample of 10 to 14 institutions, including FCBs. The 1992 reviews generally found that all regions' examination processes were efficient and effective in ensuring a sound examination product or that improvements were being made. The reports did not cite any substantive problems with the integrity of examination reports or CAMEL ratings. They did cite various procedural deficiencies, but none that materially affected the examination reports. For example, one field office did not adequately document contacts between its examination teams and the headquarters ED. Two field offices had not consistently met FCA's guideline for the timely issuance of examination reports. In one instance, the peer review team disagreed with how an examination team classified certain loans, although both identified them as risky loans. The difference did not have a material effect on the examination, but it did serve to raise a discussion about differences in interpretations of regulations and guidelines. The regional director believed this discussion

would help bring a more consistent officewide application of classification criteria.

Peer reviews were not done in 1991 because the guidelines were being revised. As of March 1993, FCA decided to maintain a flexible schedule of peer reviews that are to occur every 12 to 18 months.

OIG's Work Provides Independent Review

The OIG reviews and makes recommendations on examination planning, monitoring, and oversight of borrower rights provisions. (We discuss borrower rights in ch. 4.) FCA has generally concurred with the OIG's recommendations and addressed the deficiencies.

A November 1991 OIG audit on examination planning reviewed 42 examination plans, visited 5 field offices (including 1 of those we visited), talked with examiners, and surveyed System institutions. The OIG found the following areas, among others, were adequately considered in planning examinations:

- follow-up on internal audit reports, previous examination findings, and enforcement actions;
- management control and information systems;
- compliance with laws, regulations, and procedures; and
- diversity among assets to be reviewed.[21]

The OIG report contained some suggestions that would improve efficiency in planning. We were interested in the OIG suggestion that OE develop a system to ensure issues of concern would be included in the examination plans. OE subsequently revised guidance on examination planning to incorporate risk-based examinations and the need for customizing the scope of examinations to specific areas of concern.

The November 1990 OIG report on FCA's monitoring of institutions resulted in a comprehensive guidance we discuss later in this chapter. The OIG audit reviewed guidance and management's expectations for monitoring activities as well as evaluated monitoring of 38 institutions. It found monitoring and reporting results were inconsistent among examination teams because of the lack of comprehensive guidance. It specifically recommended that FCA require institutions to provide outside auditor reports for its review as soon as available, rather than doing so as part of

[21]The assets selected were significantly different from those reviewed in the preceding exams and the scopes were sufficiently different to indicate the examiners would test different parts of an institution's operations.

the examination process. In addition, the OIG report said coordination between the OE and the ED needed improvement. Our work shows that FCA has effectively addressed these deficiencies. Monitoring activities keep FCA up to date. Examiners not only review audit reports as part of their off-site monitoring, but they periodically meet with outside auditors. We did not identify any problems that occurred because of a lack of coordination between OE and ED when enforcement actions were involved.

Monitoring Is Timely, and Follow-Up Is Appropriate

As with examinations, FCA customizes monitoring activities to the institutions and bases them on risk within a framework of minimum requirements. We found that FCA's monitoring of banks, large associations, and those under enforcement actions is an ongoing process. We found that FCA monitors problem and large institutions monthly. FCA examiners analyze both quantitative and qualitative information on System institutions between annual examinations. FCA officials use the results of these analyses to address potential problems they identify and to plan the next examination.

Guidance Is Extensive, and Examiners Appropriately Adapt It to Institutions

FCA's objectives in monitoring institutions between the annual examinations are to

- "ensure that corrective measures are taken by institutions in a timely manner,
- provide timely recognition of changing risk in each System institution,
- provide input to examination planning, and
- enhance communication between individual institutions and the FCA."

Each examination team is responsible for monitoring the institutions it examines, and the Examination Manual sets basic requirements that some field offices supplement. FCA guidance states that each field office's associate regional director must establish an adequate monitoring effort. It encourages each office to tailor the type of, frequency of, and documentation for monitoring to an institution's risk level.

We reviewed monitoring files at 4 FCA field offices for 21 judgmentally selected FCBS and associations with FCA-assigned CAMEL 2, 3, or 4 ratings. No institutions were rated 1 or 5 when we selected this group. Some of the institutions were under enforcement actions; therefore, examination staff were also responsible for coordinating with FCA's ED. We reviewed FCA headquarters, regional office, and field office guidance and discussed it

with the appropriate FCA officials. We also talked with examiners and other FCA officials involved in monitoring the selected institutions.

Although we found that each field office met the objectives for monitoring its institutions, the level of documentation varied. Monitoring activities varied according to each institution's problems. Monitoring is to begin when the examiners complete an examination and a supervisory official approves the examiner's proposed monitoring plan; the level of supervisory approval varies depending on the size and condition of the institution. We found that regional directors reviewed and approved the plans for monitoring banks, for example.

FCA officials told us the starting point for developing each monitoring plan was the institution's current CAMEL rating. Other factors examiners considered included asset size and current enforcement actions. Monitoring strategies are to appear in each field office's annual examination or strategic plan and for each institution in the Rating System Summary form (FCA Form 1000) and/or Supervisory Action Monitoring Memo prepared at the end of an examination.

Examiners are to record a general strategy for monitoring on FCA Form 1000; some field offices require a more detailed written plan. Among other information, FCA Form 1000 displays current key financial data and data for four other points in time (past). The form contains past CAMEL component ratings and a short version of the examiner's assessment of problems related to each CAMEL component. Using that information, examiners estimate the number of staff days needed for monitoring and for doing the next examination.

Examiners often attend meetings of institutions' boards or board committees and meet with institution officials to discuss issues of concern. In addition, they periodically meet with outside auditors and sometimes with officials of the Assistance Board. Examiners typically prepare a report on the results of their activities and specify any action they will take and any effect it may have on the next examination. For example, in a monitoring report for one of the banks, the examiner commented that conditions remained stable but that nonperforming loan volume had increased. The report noted that the increase might be explained by improved identification and reporting. However, it also noted that future reviews should watch for a continuing trend. The report also mentioned the bank's investment portfolio and FCA's concern about the high level of investments compared to assets. Discussions with the bank

were to continue regarding the appropriate investment level, according to the examiner.

When an institution is under an enforcement action, FCA's ED uses field office monitoring to gauge compliance. FCA policy requires examiners to send copies of monitoring reports to the Office of Regulatory Enforcement, and with a few exceptions, we found this was done. In addition, System institutions provide information required under enforcement actions to both their assigned field office and to ED. We did not identify any monitoring or coordination problems between OE and ED, and institution officials told us coordination within FCA was good.

We could not determine the extent of monitoring at one field office we visited because examiners did not fully document these activities. This field office required less evidence of monitoring activities than did the others. FCA's own peer reviews of this office also criticized some elements of the monitoring program. During our review, however, the new director for this field office established new standards. If they are met, the standards will ensure adequate monitoring and documentation in the future.

Examiners Use a Variety of Monitoring Tools

At a minimum, FCA requires examiners to review each institution's quarterly call reports and stockholder disclosure reports. It recommends a variety of quantitative and qualitative information examiners might use to analyze matters, such as performance trends, internal controls, and possible effects of economic or climatic conditions. The suggested sources of information include

- information FCA generates from the quarterly call reports,
- FCA's Loan Accounts Report System (LARS),
- special FCA studies,
- reports of internal and external auditors,
- minutes of the institution's board meetings,
- information sent to stockholders, and
- other information submitted by the institution.

FCA requires System institutions to file financial data each quarter just as regulators of other financial institutions do. The accuracy of these data is important because FCA uses them for off-site monitoring and special analyses of the System. Misrepresentation of information on call reports is a regulatory violation. We found that FCA tries to ensure the accuracy of

call data in two ways. First, examiners and other field office officials review call data. Then, headquarters officials make computerized edit-checks when the data are submitted.

Examiners cited 8 of the 21 institutions we reviewed, (i.e., the 4 banks and 17 associations in our monitoring sample) for inaccuracies in their call reports and required that corrections be filed for 7 of the reports. Frequently the inaccuracies were related to high-risk and nonperforming assets. Often the changes were required because examiners reclassified loans.

In addition to the call reports themselves, examiners use two reports generated from call data for off-site monitoring. The Uniform Performance Report and a supplementary Key Indicators Report provide different sets of financial ratios and percentages for different periods of time. The latter highlights ratios that fall outside FCA-prescribed tolerance ranges for a particular institution. In addition, examiners or other users, can specify different ranges.

FCA also maintains LARS, a database on individual loans—e.g., for size, classification, performance status, as well as loan portfolio totals. LARS was principally developed for System-wide and policy analyses but is also intended for examiners' use. We found, however, that examiners generally do not use LARS because, according to an FCA official, it is too complicated. Headquarters officials acknowledged that LARS is complex; they are studying ways to make the information available in a user-friendly form.[22] Headquarters staff, however, have used LARS to analyze the possible effects of adverse conditions or lending concentrations. For example, recent FCA reports considered the effects of the continuing drought in the West. LARS enabled an analyst to focus on loans tied to the most drought-vulnerable crops. One report analyzed the risk associated with loan concentrations in the dairy industry and another, the large volumes of loans to a small number of commodities. OE provides the results of these analyses to field staff who have used them to assess the risk faced by individual institutions. LARS maintains unique information on loans that is not available from other databases. It could be helpful to examiners if provided in a friendlier computer environment. FCA contracted in

[22]A congressionally required management study of FCA (Review of the Farm Credit Administration's Current Operational and Management Structure, Riso & Dempsey, Mar. 2, 1992) questioned the usefulness of LARS in the examination process and the overall efficiency of FCA's computer operations. It recommended FCA undertake a comprehensive study of its application of computer technologies to its activities, which FCA began in 1992.

December 1992 for a comprehensive study of its application of computer technology. Scheduled for completion in 1993, it includes a review of LARS.

New Initiatives

FCA Now Discloses CAMEL Ratings

In February 1992, FCA began disclosing the CAMEL composite rating to each institution. FCA adopted this rating policy in response to what it called System institutions' "overwhelming" interest in knowing their CAMEL ratings and to improve communications with the institutions. FCA officials told us they did not reveal the ratings previously so that institution management would focus on resolving the problems cited in examination reports. The officials see a danger in management concentrating on improving its rating rather than on resolving the underlying problems. FCA reveals the ratings to the boards of directors and chief executive officers, who must keep them confidential. Other bank regulators follow a similar policy of disclosing composite ratings. In April 1993, FCA adopted a policy of revealing each component rating as well.

Computer Model Produces Quantitative Ratings

FCA has a technique for comparing institutions' current financial trends with the most recent CAMEL scores examiners assign. The Risk Analysis Division generates a CAMEL-type rating by computing various financial ratios from the call report data each quarter. Through regression analysis, officials can also determine which financial ratios were most significant in the examiner-assigned rating. FCA refers to this as an Early Warning System (EWS), a program that it began developing in 1989.[23] Headquarters officials use it to review institution trends. Ultimately, officials hope EWS will predict instability, deteriorating trends, or the failure of institutions.

EWS reports contrast the quantitative rating for banks and direct lending associations with the most recent examiner-assigned rating and flag the differences. Over a period of nine quarters ending September 30, 1992, the ratings for FCBs were the same with only a few exceptions. Out of 83 computer-generated EWS ratings, only 5 differed from the most current CAMEL ratings assigned by the examiners when the report was generated. In two instances, at one bank the EWS ratings were worse than those

[23]Monitoring systems used by the Funding Corporation and by the banks as a group are discussed in chapter 4. They, like EWS, measure performance in capital, earnings, and asset quality. None of these monitoring tools use exactly the same financial ratios. Also, EWS generates a rating for individual institutions, while the Funding Corporation generates composite ratings for System districts.

assigned by the examiner. For three other banks, the EWS rating was better. Results were similar for EWS ratings for associations. The report, which was generated with September 30, 1992, call data for 167 associations, rated 3 associations worse than examiners had and rated 25 of them better.

OE officials told us they use the reports to monitor changes in institutions and to compare a strictly quantitative rating with a subjective rating. They emphasized that the reports are not intended to second-guess examiners whose judgment is crucial in assigning a rating that best reflects an institution's condition. OE officials do not want the computer rating to influence examiners or to be regarded as the "right" rating. OE provides the reports to regional directors without specific guidance regarding their use or further distribution.

We did not find that the EWS reports contribute to FCA's monitoring of banks because field offices monitor them continuously. FCA staff are well aware of changes at banks on at least a monthly basis, as we discussed earlier in this chapter. The reports on associations are useful, in our opinion, for flagging any deterioration that may occur between annual examinations. They may become more useful in monitoring associations given FCA's new power to limit the scope of its examinations. A clear policy and guidelines to field office and headquarters officials regarding the use of EWS would be beneficial. FCA has not set a specific deadline for producing such guidance.

Testing Off-Site Examinations

FCA is testing the feasibility of doing off-site examinations of selected associations, which would be done at FCA offices. FCA officials believe using off-site examinations will enhance efficiency and effectiveness and be especially useful if significant resources have to be redirected to troubled areas of the System. Three such examinations were done in 1991, and four more were completed in 1992. For 1993 FCA has scheduled five off-site examinations. FCA officials indicated the program could expand in 1993 because of demands on FCA resources.

To be eligible for an off-site examination, an association must (1) be a direct lender association with component CAMEL ratings of 1 or 2, (2) have assets of less than $250 million, and (3) have had no enforcement actions in place during the previous 3 years. It must also have had an on-site examination the previous year. FCA reports that the off-site examinations save it an average of 60 staff days from the prior year's on-site

examination. The prior year's examinations averaged 100 staff days. FCA officials note that the subsequent on-site examinations for these same institutions take 10 to 20 days more than the last on-site examinations. Thus, FCA's calculations suggest that the net reduction is closer to 40 to 50 staff days.

The conservative criteria limit savings from potential off-site examinations. In addition, examiners can always go to the site if they detect problems during the off-site review. This occurred with two examinations in 1991 that began off-site. FCA officials told us they will be very cautious in testing the feasibility of off-site examinations and their future application. For 1994, FCA officials said that 39 institutions appeared to be candidates for off-site examinations. If off-site examinations were done for half of the 39 institutions (to allow half to be done the following year), using FCA estimates, some 800 staff days representing $370,000 could be applied to other regulatory work.

FCA Now Considers Institution Condition in Assessing Costs

FCA is funded by the System; it does not receive any taxpayer funds. Previously, FCA essentially assessed institutions for its costs based on their asset size. FCA used a complex formula incorporating comparisons of the average share of System loans outstanding and loans made for a fixed time preceding the assessment for the institutions in each district. The System criticized FCA's costs for being too high. In February 1993, FCA adopted an assessment method for banks, associations, and other System entities that considers institution condition along with asset size so that institutions exhibiting higher risk would pay a larger share of the cost of FCA regulation. This change is consistent with FCA's risk-based examination activities, and it could be a positive force in compelling institutions toward safe and sound operations to avoid higher regulatory costs.

Assessment Base Unchanged Since 1989

Assessments were based on asset size percentages from 1989 calculations for each district's FCB and associations, the three banks for cooperatives, and FICB of Jackson. FCA assessed each FCB for the entire district and some FCBS allocated shares to associations. Because of structural changes in the System due to the 1987 act, FCA determined its existing assessment procedures might result in inequities. Some System institutions also expressed interest in FCA revising its methodology to eliminate perceived inequities.

New Assessment Method Will Reward Institutions That Improve Condition

In 1992, a committee of FCA and System representatives developed the new method for assessing FCA's costs (including operating costs and a

necessary reserve). Under the new method, both banks and associations will be assessed. Thirty percent of the assessment will be apportioned on a pro rata basis using the institution's average risk-adjusted assets. Seventy percent will be based on the amount of risk-adjusted assets falling into one of eight tier levels. Additionally, if an institution has a CAMEL 3 rating, its assessment based on the levels will increase by 20 percent. If the institution has a CAMEL 4 or 5 rating, the amount will increase by 40 percent. Each institution will pay a minimum of $20,000 regardless of the result of the application of the formula. The committee considers the new method equitable because it is objective, reflects costs associated with examining institutions of differing conditions, and considers economies of scale that can affect examinations at large institutions. The costs FCA assesses institutions with good CAMEL ratings should be lower than those with poor ratings because FCA costs are related to the number of staff days it uses to examine and monitor institutions. FCA officials told us they estimate the staff days needed by considering each institution's asset size, CAMEL rating, and any enforcement actions. Field office staff review these staff day estimates and adjust the estimates.

We analyzed actual staff days that were used for examination activities in fiscal year 1991 and found that asset size and CAMEL rating are significant factors in deciding staff day allocations. We found that each increase to a riskier rating category (e.g., from a CAMEL 3 to a CAMEL 4 rating) added an average of 20 staff days. Therefore, institutions that improve their condition and receive a better CAMEL rating will likely reduce their share of the cost of FCA overseeing them.

The new method will be consistent with FCA's mission of ensuring safety and soundness at System institutions. It can provide positive reinforcement for an institution to improve its condition.

Conclusions

FCA's examination and monitoring of the System institutions we reviewed were generally comprehensive and timely and addressed key safety and soundness issues. The FCA Examination Manual and other guidance address these and other issues. In practice examiners often used analytical techniques and documented their work in ways that differed from those described in the manual, much of which dates from about 1988. The techniques they used, however, seemed appropriate. An updated manual should provide guidance that incorporates the latest analytical techniques and responds to the changes that have occurred in bank-association relationships.

FCA customizes examinations and monitoring for each individual institution within a framework of minimum standards. FCA field staff, therefore, have considerable latitude in deciding the scope of both examinations and ongoing monitoring. We believe it is appropriate for FCA to tailor its regulation of System institutions within the minimum standards set by regulation because of diversity in the System, the quality controls that are in place, and the extensive nature of FCA's oversight. FCA has had quality controls at headquarters, regional, and field office levels to help ensure that areas of risk were carefully examined and appropriate corrective actions were required. Recent changes in the law have given FCA the authority to determine the scope of examinations. This increase in authority makes FCA's control over the quality of its examinations even more vital. OE's Quality Assurance Review Program (i.e., annual peer reviews) has contributed to examination quality, but FCA may schedule the peer reviews less frequently in the future.

In loan categories examiners judged to be high risk (such as direct loans and participation loans) the examiners reviewed loan samples representing large dollar amounts within each category. Because of their size, these samples appear to have been acceptable, and any error in the unreviewed portion of the high-risk categories of the portfolio would have been immaterial. We believe the reviews of these high-risk categories were adequate.

Examiners reviewed small samples of long-term mortgage loans because FCA believes such loans are low risk. They judgmentally selected the mortgage loans reviewed; therefore, their samples were not representative of the mortgage portfolio. The examiners usually supplemented these reviews with the results of other work, such as outside auditors' reports and FCA examinations of FLBAS. Nevertheless, we believe FCA's method of selecting long-term mortgage loans to review should be improved.

Examiners identified many deficiencies at the institutions we reviewed and required appropriate corrective actions. The CAMEL ratings the examiners assigned were consistent with the nature and severity of the problems they identified. In February 1992 FCA began to reveal the CAMEL composite rating to institutions. It is appropriate that they, like other regulators, do so.

FCA has two computerized tools that are intended to aid in monitoring and examining institutions and generally contribute to FCA's mission of ensuring safety and soundness in the Farm Credit System. One, LARS, is

only partially beneficial because it is not regarded by examiners and others as user friendly. FCA has not issued specific guidance concerning the second, EWS.

LARS, the database on loans held by all System institutions, is the only database containing loan portfolio data. FCA headquarters staff have used the data to analyze loan portfolios overall and produced several reports that were useful in alerting examination staff to potential problems. Examiners, however, virtually never use the database in monitoring or examining individual institutions. System institutions and FCA use valuable resources in maintaining this database, which could be helpful to examiners if it were more accessible. FCA, through a contractor, is now studying its application of computer technology, including LARS.

EWS, a computer model that generates a CAMEL-type rating each quarter, appears to serve a useful purpose in monitoring association trends. It seems less useful in monitoring banks because FCA monitors them more often through other means. The model is intended to predict instability, deteriorating trends, or the failure of institutions. Headquarters distributes the EWS reports to staff without written guidelines or requirements regarding their use.

System institutions have various limits on the amounts of credit they can extend to one borrower. Until December 31, 1993, regulations limit an FCB's indebtedness to one borrower to 20 percent of capital and surplus. Associations are limited to 50 percent or 100 percent under some circumstances. Concentrations of loans result in insufficient portfolio diversification and have been associated with problems at financial institutions. Effective January 1, 1994, FCA regulations will limit FCB and association lending to 25 percent of capital as defined in the regulation. This change will bring the limit for these System institutions more in line with the limits of other financial institutions.

Lending limits for banks for cooperatives vary according to the type of loan, with 25 percent of capital for term debt, 35 percent for seasonal debt, and with an overall limit on lending to one borrower of 50 percent. The law prohibits FCA from lowering the limits for CoBank, but not for the other banks for cooperatives. We believe FCA should have authority to change the limits for CoBank just as it has for all other System institutions.

Recommendation to Congress

To enable FCA to effectively ensure the safety and soundness of CoBank, we recommend that Congress amend the 1987 act to give FCA authority to set appropriate lending limits for this special bank.

Recommendations to FCA

To further enhance the effectiveness of FCA's regulation of Farm Credit System institutions, we recommend that the FCA board take the following actions:

- ensure that the Examination Manual is revised during 1993,
- adopt a policy requiring annual peer reviews of the examination and monitoring work of field and regional offices,
- require examiners to make comprehensive reviews of all segments of the loan portfolio with random sampling used where appropriate within the context of the risk-based approach to examinations,
- decide whether LARS' contributions to FCA's oversight exceeds its costs and if making LARS easier for examiners to use would have benefits that would exceed the costs of modifications, and
- issue guidelines for the use of EWS reports.

Agency Comments

FCA did not object to any of our recommendations to enhance its regulatory processes. See app. IV for the full text of FCA's comments. CoBank objected to our recommendation that Congress give FCA authority to set CoBank's lending limits. The System endorsed CoBank's comments. In general, CoBank stated that lowering the lending limits is unwarranted given its current operations and FCA's assessment of them. FCA expressly concurred with our recommendation. We address CoBank's comments on pages 74-75. See appendix VII for the full text of CoBank's comments and our response.

FCA Used Strong Enforcement Actions

At the six banks we reviewed, we found that FCA used its enforcement authority to address problems examiners identified that threatened safety and soundness. FCA's oversight has benefited from a political climate favorable to strong enforcement, the infusion of federal assistance to severely troubled banks, the Assistance Board's proactive monitoring, recently improved economic conditions, and other factors. Of the six banks we reviewed, two have fully resolved their problems, and three have made steady progress. One bank has been slow to comply with FCA's orders and has experienced additional problems.

Enforcement actions are initially recommended by examination field staff and ultimately approved by the FCA board. The process of taking action uses the expertise of several offices. FCA tailors enforcement actions to each institution's problems. We did not identify any conflicts in coordination among the field and headquarters staff who monitor the actions.

FCA's Forceful Stance Aided by External Conditions

Outside forces have aided FCA's efforts in getting banks to resolve their problems. The political climate favored strong, aggressive regulation of financial institutions. Congress, in the 1987 act, provided funds to rescue the Farm Credit System. The serious condition of some System institutions and the underlying problems were well known. In addition, the extent of the savings and loan industry's problems was becoming known, and its regulator was being criticized for lax enforcement. This environment supported forceful FCA action. As we discuss in chapter 4, we found that the work of the Assistance Board complemented FCA's and focused on getting the banks to resolve many of the same problems FCA cited in its enforcement actions.

Most recently, favorable conditions in the agricultural economy have enabled banks to improve their financial conditions. With increased earnings, a bank can better afford to absorb losses from old problem assets. Although several bank districts experienced severe weather conditions during 1989 through 1992, most banks coped with the adverse effects.

FCA Took Strong Actions

No Characteristics of Lax Enforcement

Since FCA became an arm's-length regulator, it has taken strong, timely enforcement actions and closely monitored institutions' compliance with those actions. These and other factors show that FCA is appropriately using its enforcement powers. In evaluating FCA's enforcement efforts, we looked for signs of lax enforcement similar to those we have found in our evaluations of other financial institution regulators. For example, the previous regulator of savings and loans, the Federal Home Loan Bank Board, did not always take enforcement actions even after examiners identified serious problems. When actions were taken, they were not always the strongest available. We also identified this pattern of not promptly using forceful actions in some thrift and bank failures.[1]

In contrast, after FCA examiners identified serious problems at the six banks we reviewed, the FCA board approved enforcement action against them all within 90 days of ED's receipt of the examination report.

The law specifically empowers FCA to issue cease and desist (C&D) orders, suspend or remove directors and officers, assess civil money penalties, and appoint a conservator or receiver for an institution. Those are the most severe sanctions available to FCA. In addition, FCA also uses two other methods, which are enforceable in a C&D proceeding, to compel an institution to address its problems: (1) agreements and (2) conditions of merger or reorganization. FCA uses informal supervisory letters when problems are less severe or as a follow-up to an existing enforcement action. See appendix II for a detailed description of each action.

Until April 1, 1991, FCA ED's standard for timeliness in taking formal enforcement actions was 30 days from the time ED received the examiner's recommendation for action until a recommendation was presented to the FCA board for approval. In April 1991, ED changed the standard to 90 days for formal actions and 45 days for informal actions. An ED official told us the standard was changed because ED found that 30 days did not provide enough time for consultation among the examination, enforcement, and

[1]Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989); Troubled Thrifts: Bank Board Use of Enforcement Actions (GAO/GGD-89-68BR, Apr. 13, 1989); and Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991).

legal staff before the next FCA board meeting. We believe the current 90- and 45-day standards are reasonable and appropriate.

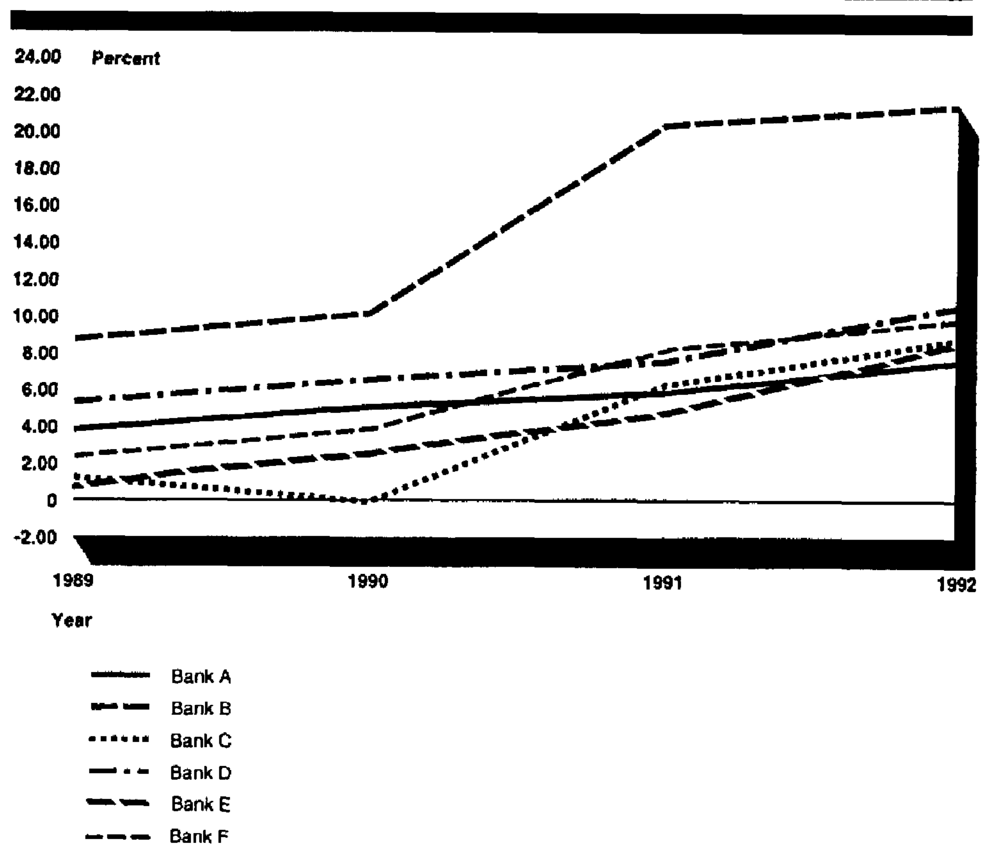
FCA has generally met its standards for timeliness. FCA took six formal enforcement actions against the six banks we reviewed before April 1, 1991; it met its 30-day standard in one case, and the other actions were taken within 90 days. After April 1, 1991, FCA took two other formal actions as a result of problems examiners identified and met its 90-day standard each time. FCA took eight informal enforcement actions (i.e., follow-up supervisory letters) against the six banks from January 1, 1989, through March 31, 1991, when there was no standard for such actions. Five letters were issued within 45 days, and the remaining three, within 90 days. From April 1, 1991, through December 31, 1992, FCA took seven informal actions: four within 45 days and the remaining three within 63 days.

Other characteristics of FCA's enforcement activities also reflect a strong enforcement effort. FCA regularly monitors compliance with all enforcement actions. For example, FCA requires quarterly and sometimes monthly progress reports and meets with bank officials and boards of directors to review progress. It examines some banks more than once a year. FCA officials of ED and OE, both field and headquarters, are involved. The coordination we observed among the various FCA levels and offices was good; we did not find any conflicts in messages FCA conveyed to the banks. Examination reports also evaluate compliance with each individual requirement of an enforcement action. Typically, FCA subsequently issues a follow-up supervisory letter identifying progress; problems that still need attention; and, if appropriate, modifying the enforcement action by relaxing its requirements.

Figures 3.1 through 3.3 illustrate another indicator of FCA's strong enforcement effort at the banks we reviewed: bank financial condition generally stabilized or improved over time after FCA took enforcement action. FCA took enforcement action against Bank D in 1988; against Banks B, C, E, and F in 1989; and against Bank A in 1990. Many factors contributed to the improvements, e.g., a more favorable agricultural economy and changes made by bank boards of directors and managers. In the three assisted banks we reviewed, the infusion of federal assistance (which immediately improved their capital ratios) and the additional oversight of the Assistance Board were strong positive factors. Nevertheless, we believe FCA's enforcement actions played an important role. As we discuss in the following section, the enforcement actions addressed violations of laws, regulations, and weaknesses in safety and

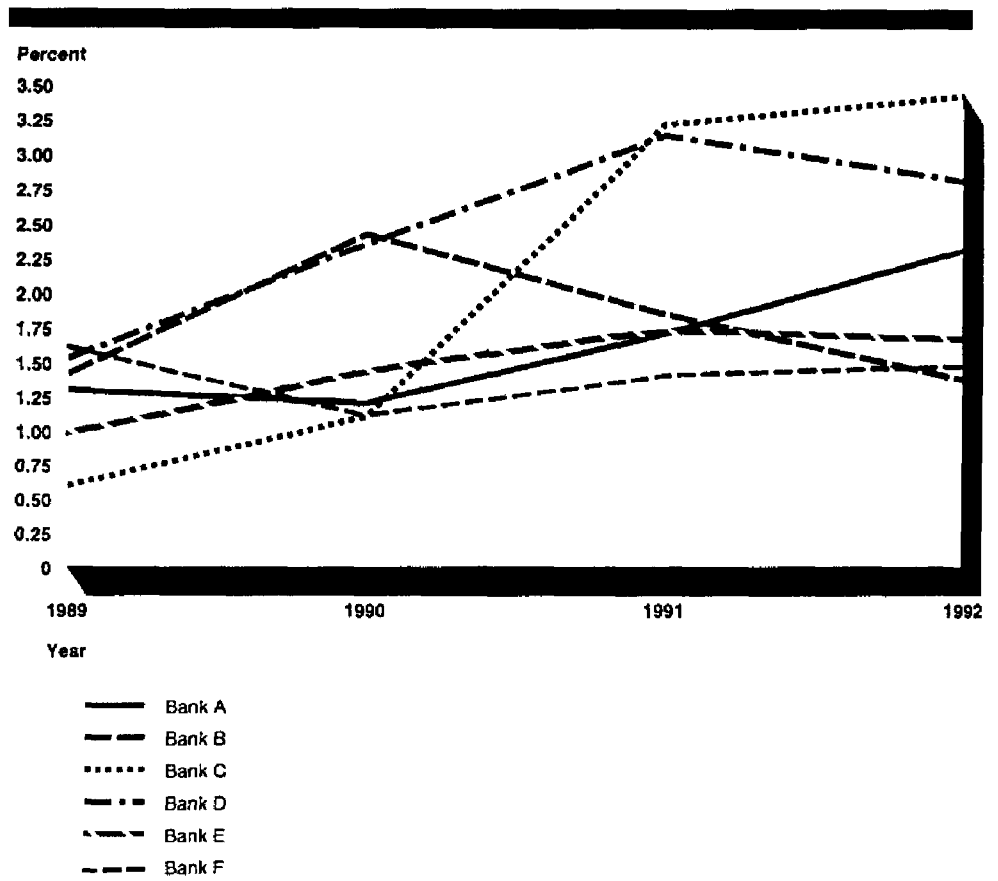
soundness. Those violations and weaknesses caused financial harm. The progressive improvement at five of the six banks was evident in FCA monitoring reports, the supervisory letters, exam and financial reports, and other documents.

Figure 3.1: Permanent Capital Ratios for Six Selected Banks



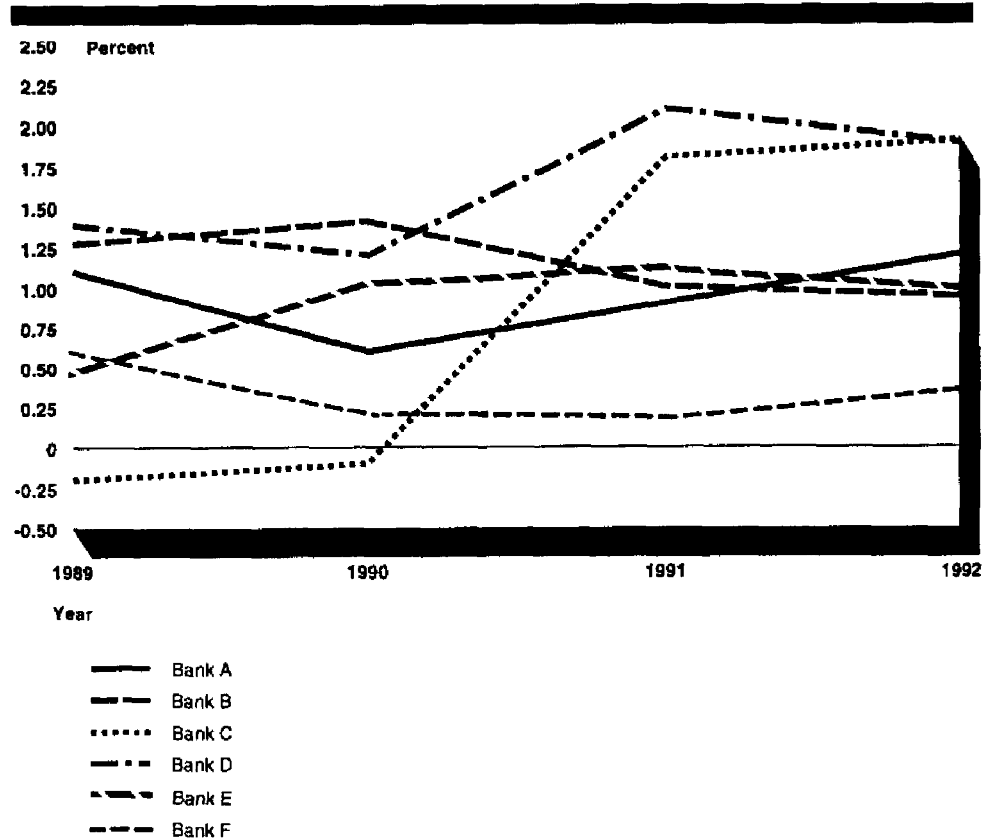
Source: FCA rating system summary data.

Figure 3.2: Net Interest Margins for Six Selected Banks



Source: FCA rating system summary data.

Figure 3.3: Return on Assets for Six Selected Banks



Source: FCA rating system summary data.

Problems Resolved at Two Banks and FCA Removed Enforcement Actions

The two banks, Banks A and B, that resolved all FCA-cited problems had similar characteristics. Both were basically financially sound but had some conditions or practices that threatened that soundness. Their boards of directors and managers cooperated with FCA (although they did not always agree with FCA), and they promptly took the corrective actions FCA required.

FCA's agreement at Bank B focused on asset and credit administration problems. Thirty-five percent of the bank's total loan portfolio was adversely classified as of June 30, 1989. The January 1989 agreement required the bank to prepare individual plans to correct the problems of all adversely classified assets over $300,000. FCA accepted the plans and required the bank to submit quarterly reports on those assets. The

agreement generally prohibited extending credit, directly or indirectly, to any borrower with adversely classified loans. Indirect extensions of credit include capitalizing interest, renewing, extending, deferring, or reamortizing loans. Exceptions on credits of $500,000 or more generally required the approval of the board of directors or a delegated committee. Bank B had to improve its credit and collateral files and ensure that credit was not granted to borrowers until the bank obtained and analyzed current, adequate, and reliable credit and collateral information. In addition, it had to ensure that associations corrected credit exceptions in their portfolios.

By October 1989, Bank B had complied with the requirements designed to improve the quality of poor assets, had stopped extending credit to borrowers with adverse loans, and had partially complied with requirements to improve credit administration at associations. Adversely classified assets had decreased to 11 percent, and nonaccrual assets were 4 percent of total loans by year-end 1989. The bank's permanent capital ratio had risen to 9 percent from 6.5 percent in 1988.

By 1990, FCA determined that Bank B had complied with all of the agreement's provisions. Adversely classified assets were down to 9 percent and nonaccrual loans, to 3.6 percent. The bank's capital ratio was at 10 percent. Examiners noted some weaknesses in internal controls but termed them "mostly technical in nature" and said they did not threaten safety and soundness. They recommended that the agreement be terminated, and the FCA board concurred. This bank continued to improve; less than 1 percent of its assets was adversely classified in 1992, and its capital ratio was 21 percent.

Officials at Bank A, where FCA also terminated its agreement, did not think that the enforcement action was justified. Bank officials knew many weaknesses existed in 1989 after the bank was created by merger, and they told us they had a 3-year plan to address them. FCA's 1989 examination, which was completed 5 months after the merger, identified specific problems with various policies and procedures, asset quality, internal controls, internal audits, and other issues. The FCA examination report urged the board of directors and management to exert more control over the direction of the bank through improved policies, procedures, and internal controls. Examiners did not think the problems were severe enough to warrant a poor CAMEL rating, however.

By mid-1990, FCA believed Bank A had not made adequate progress in addressing its problems and identified new problems in liquidity management that as one FCA official said, tipped the scale toward FCA's taking enforcement action. This bank incorrectly identified the credit or performance classifications of many loans, which resulted in inaccurate call reports and loan status disclosure. The bank's internal audit function was inadequate, and deficiencies in both the bank's board and management's performance continued. FCA rated the bank a CAMEL 3 and an agreement was signed in December 1990.

The process of liquidity management involves a bank's ensuring that it can meet its short-term cash needs. Through routine monitoring in January 1990, FCA saw that the bank was buying long-term mortgage-backed securities. FCA cautioned the bank that such investments involved some risk. Bank A, however, continued to buy the investments—until they totaled almost 80 percent of the bank's investment portfolio. About 27 percent of those mortgage-backed securities had fixed rates. FCA identified this as a violation of regulations because the investments did not coincide with the bank's liquidity needs and its policies did not set appropriate investment controls. FCA required the bank to sell its fixed-rate investments and revise and adopt a new investment and liquidity policy within 45 days.

The corrections FCA required of Bank A for asset problems were similar to those required of Bank B. In addition, FCA required Bank A to revise the credit and performance status classifications of its assets to match FCA's classifications; correct and refile its call reports; and, in the next report to shareholders, disclose that its high-risk loans were previously understated.

Examiners criticized Bank A's internal audit and credit review programs because they had not identified the credit and financial operations problems FCA found. The scope and depth of those programs were not directed to evaluate the adequacy and effectiveness of policies and procedures. In addition, the bank did not have adequate processes for ensuring that corrections were made to problems the internal reviews identified in 1989. FCA required the bank, using an outside consultant, to complete a study on its internal audit and loan review programs within 65 days. A plan, including time frames, to implement changes in the programs was due 50 days after the study.

By September 1991, the bank had substantially complied with all but one of the provisions of the agreement—it was still correcting problems with

individual assets. The bank had revised its policies and procedures, had a plan for improving its internal audit and loan review programs, and had taken other actions. At the recommendation of its examination and enforcement staff, the FCA board left the action in place to help in monitoring the changes. It terminated the action in July 1992.

FCA Modified Actions as Three Banks Progressed in Resolving Problems

Banks C, D, and E have made steady progress in addressing problems FCA identified, and FCA has revised its enforcement actions to focus on the remaining problems. FCA recognized the banks' progress, while consistently drawing attention to areas where lapses in bank performance weakened or threatened long-term viability. FCA emphasized the need to make fundamental changes in bank operations, rather than taking shortcuts to improve financial indicators temporarily. These banks received funds from the Assistance Board from 1988 through 1990 and benefited from its oversight as well as FCA's. FCA's effectiveness in regulating these banks, therefore, should be viewed in the context of the Assistance Board's proactive monitoring and the advantages its infusion of funds gave these banks. We discuss the role of the Assistance Board in detail in chapter 4.

These three banks also had another common characteristic: They made key management changes between 1986 and 1989. The management and boards of these banks cooperated with FCA and the Assistance Board. Although some bank officials told us they thought the double reporting requirements (to FCA and to the Assistance Board) were sometimes excessive, they believed both regulators were helpful. FCA issued C&D orders against Banks C and E in August and April 1989, respectively, and signed an agreement with Bank D in April 1989. All three banks were under some type of enforcement action as of May 1993. FCA continues to pressure these banks toward compliance with the enforcement actions and a level of performance that ensures long-term safety and soundness.

FCA Consistently Required Complete and Permanent Correction of Safety and Soundness Problems

FCA continued to modify and monitor the changes Bank E made in loan pricing until the bank addressed all identified weaknesses. Although the bank complied with the C&D order's requirement concerning loan pricing by 1991, FCA kept the order in effect to ensure full implementation of the bank's changes.

In the 1989 C&D order, FCA required Bank E to improve its mortgage loan pricing and to correct previously identified weaknesses in its differential loan pricing program. In 1989, examiners found significant continuing

weaknesses in loan pricing. For example, the bank had not maximized the interest rate spread on mortgage loans. Contrary to the bank board policy, the bank did not use available loan pricing strategies to retain loan volume and maximize earnings. In its examination report, FCA again called on the bank to develop and carry out the previously identified corrective actions for loan pricing and continue the other actions the bank had been taking to improve weaknesses. The bank made some improvements using better data to anticipate changes in its lending market.

Because Bank E was acting to comply with other provisions of the C&D order, examiners recommended that FCA issue a follow-up supervisory letter addressing concerns about loan pricing. By 1990, examiners found the bank had improved its pricing of long-term (mortgage) loans by more accurately considering credit risk, loan size, and geographic differentials. They also noted that the bank made corrections to its short-term pricing, such as changing the pricing decision philosophy that encouraged earnings at the association level rather than the bank level. The bank modified the differential loan pricing program, but FCA pointed out weaknesses that would slow implementation. FCA stated that the direct lender pricing (short-term loans to associations) did not consider aspects of risk, such as quality of earnings or financial and operational trends.

In its 1991 examination, FCA found that Bank E had responded to concerns about the pricing program cited in the 1988 and 1989 examinations and was in substantial compliance with the C&D order's requirements. The bank addressed the concerns about the differential pricing program for direct loans. It put adequate controls in place to ensure the program's proper implementation as well. FCA said that prior concerns about direct loans had diminished as earnings improved. Examiners did point out, however, that the bank's risk assessment of direct lenders was not as "future-oriented" as it should be and as the bank's own policy required.

The 1991 examination showed that Bank E had substantially complied with all other requirements of the C&D order. The bank's financial condition and asset quality weaknesses continued, however, and management controls needed more improvement. FCA kept the C&D order in place to ensure that corrective actions continued. This bank continued to improve in most areas of operation in 1992, and its financial condition is stronger. FCA monitors it closely and now emphasizes the continued improvements needed in asset quality.

FCA Adjusted Enforcement Actions to Bank Condition, Performance, and Response

FCA evaluates the continued appropriateness of enforcement actions on the basis of its examinations. If circumstances at the banks change, FCA revises or eliminates the actions to address the current situation. For example, because of its 1990 examination of Bank D, FCA revised and terminated some outdated requirements of the bank's agreement. Of 13 articles, 2 were terminated because of full compliance, and 3 were revised to address new activities or related deficiencies.

In a 1990 supervisory letter, FCA said the bank substantially complied with a requirement to revise and approve policies and procedures for reporting suspected criminal activity. However, examiners found two instances of suspected borrower criminal activity that were not reported to the bank's legal counsel and FCA. FCA revised the C&D order to require that management ensure the new controls over the reporting process were in place. The bank fully complied with this requirement in 1991.

By the 1991 examination, Bank D was fully complying with the agreement. FCA noted that bank management and board members continued to provide effective direction and the bank's financial condition continued to improve. However, FCA was still concerned with weaknesses in asset quality and financial condition. Due to these concerns, FCA did not remove the enforcement action, saying it encouraged continued and sustained efforts to improve bank operations. In the follow-up supervisory letter, FCA also specified actions the bank had to take, such as improving internal controls and addressing weaknesses in borrower rights, to stay in continued compliance.

In another supervisory letter after Bank D's 1992 examination, FCA officials noted progress in strengthening asset quality and financial condition. But because those areas still exhibited weaknesses, FCA modified the agreement and kept it in effect. Four articles were deleted because the bank complied with them in recent examination periods. Those articles addressed problems in accounting, reporting criminal activity, the information and reporting system, and procedures for deciding the allowance for losses. FCA retained 7 of the original 13 articles because they covered areas of operation where weaknesses remained at the bank, such as asset quality, or areas that needed continuing emphasis, such as sound business planning.

Problems Persisted at One Bank, and FCA Issued a Second C&D Order

Problems have persisted at Bank F since before 1989 because it failed to fully address the problems FCA identified in examinations and enforcement actions. Weak assets and the bank's failure to identify properly, account

for, and control risks were the fundamental problems examiners identified in the 1988 and 1989 examinations. At that time, both the bank's board of directors and management disagreed with FCA's assessment of the bank. The bank's philosophy about its role caused it to assume risks created by some associations. In addition, the district faced additional risks posed by bad weather and volatile crop and real estate values. Although some problems were corrected and the financial condition of the bank stabilized, the bank was slow to make the policy changes needed to prevent their recurrence. The effects of poor assets continued to threaten the bank, and additional problems developed. Appendix III provides detailed information on the specific problems FCA identified at Bank F and on the actions FCA took to compel the bank to correct them.

FCA took appropriate action when serious problems emerged, became increasingly specific about requirements, and monitored Bank F closely. It issued C&D orders in May 1989 and again in February 1992. The 1989 C&D order focused on improving adverse assets, which were 42 percent of the bank's portfolio. It required the bank to develop plans within 30 days for eliminating the reason for adverse classifications on loans over $300,000. Other requirements were to reduce the level of nonearning assets, prepare a 3-year business plan, and develop written procedures and controls for managing cash and investments. The 1992 C&D order addressed concerns about the bank's asset-liability management and weaknesses in its compliance with standards of conduct. That order also required an outside consultant to study how the bank's officers and board ran the bank. The consultant's May 1992 report, according to FCA officials, reflected many criticisms previously made by FCA. A new board chairperson was elected in January 1992. The chief executive officer, who had served since 1988, left the bank in July 1992. Although FCA had no formal role in their departures, FCA had consistently emphasized to the board that stronger leadership was needed.

In April 1993, FCA officials told us this bank was addressing its problems in a more comprehensive and cooperative fashion. While the problems remain serious and will not be resolved soon, FCA officials said the bank was making adequate progress. We reviewed FCA records (e.g., monitoring reports, bank financial data) that appeared to substantiate this assessment.

Conclusions

FCA took strong enforcement action in a timely manner against the six banks we reviewed. Problems that examiners found at the banks were

specifically addressed in the enforcement actions, which included time frames for bank responses. FCA monitored the banks' responses closely. It required quarterly and sometimes monthly reports, and FCA officials periodically met with bank management and/or boards of directors. Officials of the two banks that resolved their problems from 1989 through 1992 cooperated with FCA and took corrective action that addressed the weaknesses underlying their problems rather than just the results of the weaknesses. FCA terminated the enforcement actions at these banks. Three banks, which received financial assistance, had more serious problems but have made progress toward resolving them. FCA's enforcement actions at these banks were reinforced by requirements and oversight of the Assistance Board.

One bank had not made good progress in resolving its problems, and examiners began identifying new deficiencies in 1991. FCA replaced the bank's 1989 C&D order with a new one in February 1992. This bank has new leadership and has begun to address its problems. FCA took appropriate action against this bank, but the bank disagreed with FCA and was slow to correct its problems.

The Assistance Board, FCSIC, and the Funding Corporation Provide Additional Oversight to the System

Coordination and communication among FCA, the Assistance Board, and the Funding Corporation have prevented problems such as conflicts over functions and authority even though the oversight responsibilities of these bodies overlapped. Overlap existed in credit, asset-liability management, loan pricing programs, and management. In addition, FCA and FCSIC have developed plans to coordinate activities to prevent unnecessary duplication.

We found the Assistance Board and Funding Corporation had different reasons for and approaches to monitoring the activities of banks that complement FCA's safety and soundness focus as the System's regulator. Until it expired, the Assistance Board focused on monitoring the assisted banks' financial progress and ability to repay assistance. The Funding Corporation, an agent of the System, continues to focus on protecting all System banks against the risk of loss brought on them by the deteriorating financial condition of any individual bank. FCSIC is to focus on threats to the insurance fund. Since FCSIC only became fully operational in January 1993, we discuss its planned activities later in this chapter.

The Assistance Board Monitored the Activities of Assisted Banks

The Assistance Board monitored the activities of the four assisted System banks to ensure their financial progress and long-term viability. In our review of its records, we found the Assistance Board tracked trends to identify potential problems and acted once adverse trends were identified. For example, the Assistance Board asked one bank to address several questions concerning loan interest rates because it was concerned about the bank's interest rate risk due to the bank's funding strategy. The Assistance Board concentrated on ensuring that System banks were making sound business decisions that would lead to profitability and the ability to repay their financial assistance.

Assisted Banks Entered Into Agreements With the Assistance Board

As a requirement for receiving assistance, four banks signed agreements with the Assistance Board between 1988 and 1990.[1] These confidential agreements required the banks to follow sound banking practices, implement an approved business recovery plan, allow Assistance Board monitoring, and repay the assistance provided. Although all of the agreements shared certain elements, each one was tailored to a specific bank. The banks agreed to provide periodic reports, follow loan pricing guidelines, and use federal assistance funds for permitted purposes only.

[1]As of May 12, 1993, only two of the four agreements remained because two banks prepaid their assistance. FCSIC assumed the responsibility for them.

When the Assistance Board expired at the end of 1992, FCSIC began monitoring the banks' compliance with the two remaining agreements. In addition, most of the FCA field offices we visited monitored the banks' compliance with the agreements during the examination process.

Ensuring Compliance With the Agreement

The Assistance Board had several options to encourage bank compliance with the assistance agreement. It could declare a bank in violation of the agreement if (1) it failed to comply with any of the provisions of the agreement or adhere to its business and recovery plan or (2) its officers knowingly misrepresented information to the Assistance Board. The Assistance Board could suspend or terminate certification for assistance if a bank failed to comply with the terms of the assistance agreement or take any other action it deemed necessary. However, the Assistance Board had sole discretion to waive any violation. The agreements generally gave banks 10 days to correct the violation.

According to Assistance Board officials, no substantial compliance problems occurred aside from some initial reporting problems. Once the banks became accustomed to the reporting process, the problems ceased. If a bank could not comply with the agreement, it had to notify the Assistance Board, which could elect to waive the default.

Agreements and FCA Enforcement Actions

We found that FCA enforcement actions addressed many of the concerns the Assistance Board included in the assistance agreements. The messages from FCA and the Assistance Board were consistent, and according to Assistance Board officials, FCA reviewed draft agreements for any potential conflicts before their implementation. FCA's enforcement actions address correcting both one-time deficiencies and systemic problems. The Assistance Board's agreements specifically stated what was or was not permitted. At one bank, FCA and the Assistance Board both addressed capital, interest rate programs, lending practices, and credit administration. FCA gave the bank a certain amount of time to develop, adopt, and ensure implementation of policies and procedures to manage its loan pricing program and ensure that its loans were properly priced. The Assistance Board directly required the bank not to price loans below its marginal cost of funds.

One common element in agreements and enforcement actions is the requirement for an approved business plan and regular monitoring of the plan's implementation. Both FCA's enforcement actions and the Assistance Board's assistance agreements included various other reporting requirements. One bank official noted there was some duplication of

content. However, FCA needs and the Assistance Board needed the information to fulfill their respective roles. FCA's reporting requirements focus on plans to address deficiencies cited in the annual examination and new or revised FCA-required policies and procedures. The Assistance Board required ongoing reporting for monitoring compliance with the assistance agreements, such as information submitted monthly to the assisted bank's board of directors, loan interest-rate reports, and a statement signed by the chief executive officer and chief financial officer attesting to the bank's compliance with the agreement.

Monitoring Included On-Site and Off-Site Activities

The Assistance Board monitored performance of each assisted bank through liaison officers and monitoring teams, which received, reviewed, analyzed, and reported to its board on all financial, operational, and compliance activities. We found that the Assistance Board reviewed functional areas, such as finance and accounting, credit and credit administration, asset-liability management, economics, and compliance with assistance agreements. Information concerning associations indirectly benefiting from federal assistance as well as the condition of the district was included. Periodically, FCA and the Assistance Board met to discuss assisted or troubled institutions. The Assistance Board's contact with FCA occurred at both the field office and headquarters levels. In addition, the Assistance Board had access to and reviewed FCA examinations.

Assistance Board liaison officers, team members, and officials regularly attended bank board meetings. Assistance Board officials also visited some associations; however, they attended association board meetings by invitation only. During these bank and association visits, the Assistance Board staff discussed operational and/or financial concerns.

The Business Plan Was Used to Establish a Benchmark for Monitoring

Each certified institution's performance was measured against the projections made in its annual business recovery plan. This required plan addressed credit quality, asset-liability management, and the capital plan. The Assistance Board approved the business plan and used it as an "anchor" for all monitoring activities. In addition, FCA regulation requires all System institutions to annually adopt a 3-year operational and strategic business plan. FCA examiners compare bank performance against the operational and strategic plans during the annual examination.[2]

[2]As we said earlier, all institutions except FLBAs require an annual examination by FCA.

The Assistance Board not only approved the business plans of assisted banks but occasionally required assisted banks to address specific issues in their subsequent business plans. For example, in 1991, the Assistance Board asked one bank to address how the assumptions of district associations were incorporated into its plan. In addition, in 1990, the Assistance Board asked another bank to address the impact of lower government support prices for farm products. The bank's economic assumptions were compared with academic literature to determine their reasonableness. Also, the Assistance Board prepared periodic reports and compliance information throughout the year and used this information to gauge the banks' general performance and adherence to their business recovery plans.

Both the Assistance Board and FCA Monitored Bank Decisions on Restructuring Distressed Loans

The 1987 act required the boards of assisted banks to establish special asset groups and the Assistance Board to establish the National Special Asset Council (NSAC) to ensure that assisted banks were complying with certain borrower rights provisions.[3] NSAC, which had the authority to reverse decisions that did not comply with the law, sampled special asset groups' loan restructuring denials. However, NSAC did not reverse any bank decisions. While the special asset groups remain, NSAC dissolved with the expiration of the Assistance Board. We do not believe NSAC's dissolution threatens the System's member-borrowers because FCA monitors compliance with borrower rights provisions as well.

Assistance Board officials told us they relied on FCA's determination of banks' compliance with borrower rights and referred any complaints to FCA for investigation. During its existence, NSAC found only minor problems with bank compliance. For example, one bank failed to provide a review of 25 loans within the required 6 months.

FCA's Monitoring of Compliance With Borrower Rights Includes Loan Restructurings

On the basis of our reviews of FCA examinations and workpapers, we believe that FCA routinely examines and monitors borrower rights in restructuring distressed loans. FCA requires its examiners to evaluate compliance with borrower rights during annual examinations. At a minimum, examiners are supposed to test whether banks comply with the restructurings and the borrower's right of first refusal on purchasing foreclosed property. FCA also has addressed borrower rights deficiencies

[3]The law (12 U.S.C. 2202c) requires assisted institutions to review all previously unrestructured loans that were nonaccrual and decide whether to restructure. Additionally, within 6 months after a loan is placed on nonaccrual, the lender must decide whether or not to restructure.

in enforcement actions and has required one bank to develop compliance procedures and training for its employees.

FCA also monitors the number and type of violations of borrowers rights through quarterly reports from the field offices, investigates individual complaints of borrower rights violations, and has a task force to address borrower rights issues. FCA's OIG identified weaknesses in FCA's implementation of borrower rights and made several recommendations. FCA has taken actions to implement most of the OIG's recommendations. When problems are identified, FCA requires that they be corrected. As illustrated in chapter 2, our review of examinations shows that some banks continue to have problems complying with certain aspects of borrower rights.[4]

FCSIC Became Fully Operational in 1993

In addition to assuming the responsibility for the assistance agreements, FCSIC became fully operational with the ability to provide assistance in January 1993. FCSIC is to coordinate examination activities with FCA to monitor the condition and performance of System institutions. However, some bank and former Assistance Board officials were concerned that FCA and FCSIC will duplicate each other's work. We found that FCA and FCSIC have procedures to coordinate activities to prevent duplication, but it is too soon to evaluate how well these procedures work.

FCSIC Successor to Assistance Board's Assistance Agreements

In addition to managing the insurance fund and other related activities, FCSIC assumed responsibility for managing the two remaining assistance agreements. FCSIC and the Assistance Board developed plans to transfer this responsibility. The two shared information and officials from both agencies met periodically. In addition, they made joint visits to assisted banks before the Assistance Board expired to ensure continuity in oversight. The Assistance Board developed a monitoring manual to assist FCSIC in establishing its monitoring program. FCSIC officials told us they plan to use methods to monitor and enforce the assistance agreements similar to those used by the Assistance Board. FCSIC staff worked closely with Assistance Board staff in reviewing the 1993 business plans of the assisted banks.

FCSIC to Use FCA Resources

Like FCA, FCSIC is concerned with promoting safety and soundness in the System, especially as it relates to risks to the insurance fund. Although

[4]Borrower rights compliance may depend on the proper identification of distressed loans. Banks that fail to properly identify loans as distressed also violate a borrower's rights by not notifying the borrower that the loan is distressed and eligible for restructuring.

FCSIC has the authority to examine institutions in carrying out its duties, the law requires that FCSIC avoid unnecessary duplication of FCA activities. The 1992 act further requires that FCSIC rely on information obtained by FCA and if it is deemed inadequate, ask FCA to obtain additional information. FCSIC would appoint examiners only if FCA informed them that they could not comply with the request. Thus, FCSIC plans a high degree of coordination with FCA, and both agencies signed information-sharing agreements in December 1991. Communication between the two agencies will occur at the headquarters and field office levels. FCSIC plans to use FCA's monitoring systems and examination reports to help assess the risk to the insurance fund. In addition, FCSIC asked FCA to generate information through its annual examination and prior approval processes.

Special Examinations

FCA endorsed and FCSIC developed special examination procedures for use during the FCA examination process to gather information on institutions that may need financial assistance. FCSIC will request that examiners include these procedures in examinations of selected institutions. The special procedures may apply to institutions with an FCA-assigned composite CAMEL rating of 4 or 5, those with a CAMEL rating of 3 and deteriorating trends, those receiving assistance, or those recommended by the examiners for other reasons. The special examination procedures include collecting data on assets, liabilities, capital, commitments and contingencies, and nonbook assets. An analyst from FCSIC will be available to participate in the field with FCA in the special examinations. FCSIC will use this information with a model it has developed to estimate the potential liquidation costs of high-risk institutions.

When an institution poses an imminent threat of failure, FCA will perform additional examination procedures. FCSIC will use the data obtained to determine the liquidation cost, which establishes a benchmark to determine whether to provide assistance. Proper liquidation valuation is critical because the law specifies that FCSIC can provide assistance only if doing so is less expensive than liquidation, with the exception of an institution whose operation FCSIC determines is essential for providing agricultural credit services to its community. This legal limitation is similar to that placed on the National Credit Union Administration.

Impact Statements

FCA prepares statements assessing the impact on the insurance fund of certain bank proposals submitted to FCA for prior approval (e.g., mergers). According to FCA guidance, the statements are prepared for such actions as mergers, general financing agreements, and financial assistance between institutions. The impact statement is designed to ensure that

FCSIC's interests are adequately considered. The statement addresses how the proposed change or action will affect an institution's capital and future earnings. An institution's financial history and condition as well as the general character of management are considered. FCSIC officials review the impact statement and agree or disagree with the FCA staff analysis of risk posed to the insurance fund. If there is a disagreement, FCSIC's staff is to send a letter regarding the application to FCA's chief operating officer. The final decision is made by FCA's board.[5] Once FCSIC's new board is established in 1996,[6] it should ensure that its concerns are properly directed to the FCA's Board before it makes a final decision.

FCSIC Has a Nonvoting Seat on FCA's Enforcement Committee

As we discussed earlier, FCSIC plans to coordinate closely with FCA in several areas, primarily those of special examinations and prior approvals. FCSIC also has one of three nonvoting seats on FCA's six-member enforcement committee, which recommends enforcement actions to the FCA board. Other insurers, such as the Federal Deposit Insurance Corporation, have formal authorities to recommend that regulators take enforcement action. Although FCSIC does not have the formal authority to recommend enforcement actions, having a seat on the committee will allow FCSIC the opportunity to raise concerns and make its views known. Until 1996, FCSIC and FCA will share the same board members.

Effectiveness of FCSIC Operations Unknown

Because FCSIC did not become fully operational until January 1993, we could not assess its effectiveness. Its roles in assessing whether an institution should be liquidated or assisted and monitoring the institutions now being assisted are vital to protect the insurance fund and to the System. Currently, FCSIC is subject to the following outside oversight:

- It must report to Congress annually concerning its operations.
- It is subject to the Federal Managers Financial Integrity Act and its implementing circular, Office of Management and Budget (OMB) A-123, which require an annual evaluation of internal controls to ensure program and administrative activities are effectively and efficiently managed.
- It must annually report its actions to Congress and OMB to ensure audits of its programs and operations are conducted in compliance with the Comptroller General's standards and provide a list of any federal or

[5] FCSIC and FCA now share the same board but each board elects a different chairman.

[6] The board will consist of three full-time members appointed by the president.

nonfederal audits that are performed and a summary of any significant findings.[7]

In addition, FCSIC voluntarily provides independently audited financial statements to Congress, OMB, and the public, although it is not currently required by law to do so. FCSIC's independent auditor also is to perform an operational audit in 1993 beyond that of the financial statements. This audit will evaluate the effectiveness and efficiency of (1) FCSIC's first payout of funds for insurance purposes; (2) the Risk Assessment Special Examination Program; and (3) the cost test financial model, which analyzes the potential cost of liquidating a System institution. According to FCSIC's internal control policy statement, an operational audit will be performed periodically.

The reviews we mentioned include a substantial part of FCSIC's operations but will not provide a regular, comprehensive assessment of FCSIC's decisionmaking and role in assisting, monitoring, and liquidating System institutions. Therefore, periodic reviews of FCSIC operations concerning these areas are necessary to ensure that FCSIC is functioning appropriately. Likewise, FCSIC should be statutorily required to have an annual independent audit of its financial statements. Although the current board has chosen to have an independent audit, it could change this policy.

FCSIC Is Not Subject to an Inspector General

Unlike the Federal Deposit Insurance Corporation and the National Credit Union Administration, which manage the insurance funds for banks, thrifts, and credit unions, FCSIC is not subject to the oversight of an inspector general.[8] Although FCA's OIG has authority to examine FCA activities performed for FCSIC, it is unable to examine FCSIC operations without FCSIC's permission.[9] Since the insurers for other financial institutions are subject to inspector general oversight, we believe that

[7]For the Comptroller General's standards, see Government Auditing Standards, GAO (Washington, D.C.:1988), which is known as the "Yellow Book."

[8]While in the Inspector General Act "designated federal entities," such as the Federal Deposit Insurance Corporation, the National Credit Union Administration, and FCA, were required to establish an Office of Inspector General, "federal entities," such as FCSIC are required, instead, to submit annual reports to OMB and Congress detailing whether an internal audit office has been established and actions taken to ensure that audits are conducted.

[9]There is no explicit authority providing FCA's inspector general the authority to examine FCSIC activities without FCSIC's permission. The legislative history of the Inspector General Act, however, indicates that for "federal entities" such as FCSIC, "establishing an internal audit office is not the only means of ensuring compliance with the basic requirement for appropriate internal audits." The legislative history further indicates that "federal entities may obtain the needed level of internal audit from an appropriate authority such as an existing Office of Inspector General." (H.R. Rep. No. 771, 100 Cong., 2d Sess. 17 (1988).

FCSIC should be also. Federal oversight is necessary to provide a regular, comprehensive assessment of FCSIC's decisionmaking and role in assisting, monitoring, and liquidating institutions. Likewise, FCSIC's operations more closely parallel those of the National Credit Union Administration and the Federal Deposit Insurance Corporation rather than other "federal entities" that are not subject to inspector generals.[10] FCA's inspector general could also examine FCSIC operations. FCA provides administrative and legal services to FCSIC, in addition to the special examinations, and other services we discussed earlier in this chapter. Given this overlap and FCSIC's small size ($656.2 million in assets and a staff of 11), it seems unnecessary for FCSIC to have its own inspector general. We believe FCA's Inspector General could serve both entities.

FCSIC did not object to our recommendation that it be subject to an inspector general. FCA did not comment and System officials concurred with our recommendation. FCSIC expressed concern, however, that such a change might increase its costs for audit services while limiting its flexibility to retain auditors with special expertise. FCSIC is right to be cognizant of ensuring that any audit services, whether provided by OIG or an independent auditor, provide adequate benefit for the costs incurred. It seems possible that the costs FCSIC would incur by being subject to OIG audits might be essentially the same as it has expected to incur by having independent auditors conduct operational audits periodically. We note that FCA's OIG, on occasion, retains outside expertise to assist with audits or investigations. Nothing would preclude such an arrangement for review of FCSIC operations.

The Funding Corporation Monitors the System

The Funding Corporation, an agent of the System, serves several functions, including monitoring banks and associations on a combined district basis. First, the Funding Corporation provides certain consulting and accounting services, including the preparation of System-wide financial statements, and is responsible for the System's financial disclosure. In this capacity, the Funding Corporation oversees the System Audit Committee, which monitors the System's financial reporting and accounting practices. Second, it serves a minor role as "scorekeeper" under the System-initiated and bank-approved Contractual Interbank Performance Agreement (CIPA). Third, the law requires the Funding Corporation, subject to FCA approval, to determine conditions under which

[10]Other federal entities include the Commission on Civil Rights, the Pennsylvania Avenue Development Corporation, and the Interagency Council on the Homeless.

banks may participate in System-wide debt issues.[11] The Funding Corporation performs these functions in conjunction with its primary role as fiscal agent of the System responsible for issuing, marketing, and handling the debt obligations of the System banks.

We found the Funding Corporation is concerned with many of the same areas as FCA, such as asset-liability management, operations, credit quality, and disclosure. It also offers management services to banks, such as liquidity management and consulting on asset-liability management. The Funding Corporation focuses its analysis on the condition and performance of the districts (bank and related associations), rather than on individual institutions. It does not have the enforcement powers available to FCA, the System's regulator. However, because its board includes current and former bank directors and presidents, it can use peer pressure to effect change at the banks. The Funding Corporation shares each bank's analysis with the others, which gives the System an opportunity to discipline itself.

The Funding Corporation Uses Disclosure Information to Monitor the Banks

The Funding Corporation produces the System's Annual Information Statement and combined financial statements. It is also responsible for financial disclosure concerning the financial condition and performance of the System. The System's disclosure program requires that the banks submit the information necessary for disclosure to the Funding Corporation. This program was designed to ensure disclosure of material information that is essential to the System's credibility in the market, to access the market funds, and to limit the System's exposure to liability under the antifraud provisions of securities laws. The Funding Corporation also uses these financial data to monitor the condition of the banks. In the future, the Funding Corporation plans to rely primarily on information provided through the disclosure program to monitor the banks. Previously, it requested additional information under its monitoring program.

System Audit Committee

The Funding Corporation oversees the System Audit Committee, which monitors the administrative, operating, and internal accounting controls of System institutions to ensure the reliability of information provided through the disclosure program. The six-member System Audit Committee reports to the Funding Corporation board and consists of directors

[11]In addition to determining the conditions of participation, the Funding Corporation, subject to FCA's approval, determines the amount, maturities, and interest rates on behalf of the banks in each issue of joint, consolidated, or System-wide obligations.

selected from the boards of the Funding Corporation (two members), FCBS (two members), banks for cooperatives (one member), and one outside director elected by the other five members.

The System Audit Committee receives annual reports on significant internal control deficiencies and the results of the independent auditor's work. Price Waterhouse, the System auditor and the auditor for most System institutions, prepares both. Price Waterhouse considers internal control deficiencies significant if they could adversely affect the System's ability to report accurate financial data.

We found that the System Audit Committee's efforts complement FCA's efforts to urge banks and associations to improve their internal controls. The System Audit Committee performs such activities as reviewing management letters on internal control deficiencies and assessing bank programs to respond to the deficiencies. Examples of internal control issues include the need to purchase and implement a new accounting system for investments and debt, the need to improve internal accounting controls and expand reporting requirements regarding the use of derivative products, the need to implement property and equipment tracking systems fully, and the need to monitor inventories. An annual System Audit Committee report includes a summary of Price Waterhouse's audit findings addressing institution-specific and System-level matters.

The System Audit Committee receives periodic status reports from Price Waterhouse and monitors the banks' implementation of the auditor's recommendations. In addition to the Price Waterhouse recommendations to the bank boards, the System Audit Committee may contact the bank directly about specific accounting matters. The System Audit Committee contacted one bank concerning its accrual of contingencies related to possible future liabilities. This type of involvement complements FCA's focus on internal control deficiencies. In addition, we found that Price Waterhouse and FCA officials meet periodically to compare audit findings on individual institutions.

The Funding Corporation Serves as "Scorekeeper" Under CIPA

The Funding Corporation has served as "scorekeeper" under CIPA since January 1992. The banks approved CIPA in February 1992, when they established financial performance standards. The Funding Corporation generates CIPA scores using the CIPA model, which we discuss in the next section. CIPA is designed to encourage compliance with the new performance standards through built-in incentives. It also contains

provisions allowing reviews and amendments or termination of the agreement with the approval of 75 percent of the banks. CIPA also allows the banks to designate a different scorekeeper at any point.

The CIPA Model

The CIPA model measures the financial performance and condition of each district based on combined bank and association data. The model uses eight primary financial ratios that measure capital, asset quality, and earnings, which are all areas contained in FCA's CAMEL rating system discussed in chapter 2. According to Funding Corporation officials, the CIPA model was developed in consultation with Standard & Poor's and Thomson's Bankwatch and correlates with their scoring models.

CIPA includes economic incentives designed to encourage banks to comply with performance targets based on their CIPA model scores. The economic incentives involve placing assets equal to 0.05 percent of the average total liabilities of banks that fail to achieve CIPA targets in a fund managed by the Funding Corporation. The banks have 5 years to correct the problems and reclaim their segregated assets from the fund. Interest earned on those assets remains in the fund and is to be used to pay the Financial Assistance Corporation debt-related obligations of all banks. Given this small penalty, Funding Corporation officials believe management focus and peer pressure to perform well are the driving forces in improving performance. One bank failed to comply with CIPA for every quarter of 1992 and had to segregate assets totaling close to $1 million. FCA has closely monitored the situation to ensure that the penalty does not harm the institution.

Monitoring Access to the Capital Market

In 1988, the Funding Corporation began monitoring the financial condition of banks to fulfill its new statutory duty to determine conditions of participation in System-wide debt issuances. The Funding Corporation established its first monitoring program, the Market Access and Risk Alert Program (MARAP), to fulfill this duty. However, MARAP did not establish specific conditions of participation.

Through its examination function, FCA has recommended that the Funding Corporation strengthen MARAP. In 1990, the Funding Corporation began revising and updating MARAP to incorporate more comprehensive performance standards. However, revisions were halted while CIPA, which established the System's new performance standards, was being

developed. Once the CIPA model was finalized and adopted, the Funding Corporation incorporated it as the new performance measure for MARAP.[12]

In 1992, the Funding Corporation proposed the Market Access Program (MAP) to supersede MARAP.[13] The Funding Corporation believed MAP would provide a stronger basis for it to recommend that FCA restrict or deny a bank's access to the debt market. Unlike MARAP, MAP would have established the conditions necessary for a bank to participate in the issuance of System-wide debt. Due to opposition to MAP from some System banks, a workgroup of System officials developed the proposed Market Access Agreement, which was submitted to FCA for its review in February 1993, to replace MARAP and supersede MAP. Until FCA acts, MARAP remains in place.

MARAP

Because the banks are jointly and severally liable for System-wide debt, MARAP was designed to protect the System against losses to healthy banks caused by the deteriorating financial condition of troubled ones. MARAP monitors banks' risk exposure using qualitative and quantitative measures that incorporate the components of FCA's CAMEL rating system. The areas analyzed include capital, asset quality, earnings, interest rate sensitivity, liquidity, and collateral. MARAP uses alert point designations to trigger possible actions, such as requests for additional information and/or action plans and special reviews of particular banks. Alert point designations, which range from no alert to fourth alert point, are based on the CIPA model score; available collateral; supplemental ratios (e.g., percentages of change in adversely classified loans from previous year; and net interest income as a percentage of average earning assets); and any other information the Funding Corporation deems relevant. The Funding Corporation's Board of Directors makes quarterly alert point designations based on staff analyses and recommendations. Quarterly MARAP and analyses reports, including alert point designations, are distributed to all banks.

The Funding Corporation uses financial data provided through its disclosure program to monitor the banks. The Funding Corporation may request supplemental information to address specific areas of concern. Three banks provided supplemental information, such as asset-liability management reports, association information, and loan updates, before the monitoring actions were lifted. There is continuing controversy over

[12]MARAP previously had its own scoring model.

[13]Although MAP was never adopted, we mention it here to show the evolution of the Funding Corporation's effort to establish conditions of participation.

whether the Funding Corporation, an agent of the System, can require banks to submit information they decline to provide voluntarily. One bank refuses to provide any information to the Funding Corporation to be used specifically for MARAP. On the basis of the Funding Corporation's original role as a System-created fiscal agent, some bank officials question the Funding Corporation's statutory authority to establish a market access program. However, some in the System maintain that under MARAP, the Funding Corporation acts as if it were a regulator, not an agent of the System. Although the System has developed a new Market Access Agreement, MARAP will remain in place until it is implemented.

FCA's Use of Funding Corporation Information Varies by Field Office

FCA obtains Funding Corporation information primarily through its annual examination and monitoring of the Funding Corporation. We found that field office examiners generally had varying levels of understanding about the Funding Corporation and its purpose. Examiners have access to MARAP quarterly reports. Some were familiar with the information provided by the Funding Corporation, and one found the information useful. Others were unfamiliar with the Funding Corporation's role or found MARAP reports untimely and not useful.

A System Workgroup Proposes the Market Access Agreement

A System workgroup has developed a Market Access Agreement to replace the Funding Corporation's proposed MAP.[14] FCA, FCSIC, and the Funding Corporation are named as parties to the proposed agreement, along with all System banks. Under the proposed agreement, the Funding Corporation would serve as scorekeeper just as it does for CIPA. As scorekeeper, the Funding Corporation would use each bank's CIPA score, collateral figure, and permanent capital ratio to determine whether banks fit into any of three categories that indicate financial weakness as outlined in the proposed agreement. The System would establish a Monitoring and Advisory Committee composed of two representatives from each bank and the Funding Corporation. The committee would evaluate information on any troubled bank, obtain additional information from the bank, and make recommendations to the System banks (excluding any in the weaker category II or III) regarding market access for the bank in question.[15] Under the proposed agreement, FCA would not have to approve market

[14]The workgroup consists of representatives from seven banks and executive officers from the Funding Corporation and Farm Credit Council.

[15]Although each bank and the Funding Corporation have two representatives, the two only have one vote.

access restrictions and prohibitions on a case-by-case basis but would be able to override certain decisions.

System officials said that the proposed agreement represents a System "consensus," although two banks have concerns about certain provisions. Although the proposed agreement has not been formally approved by all banks, as of September 17, 1993, System officials said in their comments on our report draft (see the full text in app. V) that the boards of directors of the System banks have reviewed the proposal in detail and have "conceptually approved it." In February 1993, the System submitted the proposal to FCA and FCSIC for their consideration. System officials specified in their comments that FCA's approval is an absolute prerequisite for the proposed agreement's effectiveness. On September 9, 1993, FCA granted preliminary approval of the agreement subject to two conditions. First, it would have to be revised as the FCA board specified (there are nine specific stipulations). Second, it would have to be published in the Federal Register for public comment. The FCA stated it would take final action on the proposed agreement after these two conditions were met; it has considered any public comments; and the Board of each FCB, the three banks for cooperatives, and the Funding Corporation approve the revised agreement.

The proposed agreement vests market access monitoring responsibilities in the committee on behalf of the System banks to whom the committee would make recommendations on market access. The proposed agreement would require the Funding Corporation to discontinue MARAP, the existing market access program discussed earlier in the chapter.

We expressed several programmatic concerns about the proposed agreement. First, given the Funding Corporation's experience in monitoring market access and the fact that it handles the System's funding activities, we observed in our draft report that it is in a better position to gauge how the market would react to any changes in the financial condition of the System. We also expressed the view that the Funding Corporation is better positioned than a System committee to make market access recommendations. For these reasons, we said that the agreement would shift to a System committee functions that the Funding Corporation is performing and should continue to perform in its own right.

FCA stated in its comments (see full text in app. IV) that in considering our concerns with the proposed agreement, it is important to note that although the Funding Corporation is federally chartered, it is owned by the

System. Thus, FCA questioned the "practical value of making the Funding Corporation responsible for market access recommendations as opposed to having the banks responsible . . . ." Although we continue to believe that there are programmatic benefits to having the Funding Corporation perform market access monitoring and decisionmaking functions in its own right, we do not take issue with the Funding Corporation's decision that these functions would be better performed by the System.

FCSIC stated that the proposed agreement was consistent with the Funding Corporation's ability to monitor System institutions and that it would not erode the Funding Corporation's responsibilities regarding market access decisions, subject to FCA's approval (see app. VI).

In addition, System officials emphasized that the proposed agreement is a means of resolving certain areas of disagreement among parties within the System. For example, the System noted that although there has been continuing debate on the Funding Corporation's authority to set market access restrictions as part of its statutory duty to determine "conditions of participation" in System-wide debt issuances,[16] all parties agree that there is nothing in the statute prohibiting the Funding Corporation from setting market access restrictions through a contractual agreement. As another example, System officials referred to the controversy over the Funding Corporation's ability to collect information from System banks. Although the Funding Corporation already receives a substantial amount of information from the banks as their disclosure agent, the controversy centers on the Funding Corporation's request for information needed for market access purposes.

System officials stated that through the proposed agreement, all banks would consent "to provide information needed to assess the financial condition of a financially-troubled bank and the merits of its continued participation in the issuance of System-wide debt securities." In addition, FCA noted in its comments that the proposed agreement's requirement for all banks to provide information through the committee will enhance the Funding Corporation's ability to monitor and analyze the condition of System institutions. While the proposed agreement has a provision for banks to obtain information on troubled banks from the committee, it does not explicitly extend this right to the Funding Corporation. However, one of FCA's required revisions will address this matter. The agreement

[16]12 U.S.C. 2160 provides, in pertinent part, that the Funding Corporation "acting for the banks of the Farm Credit System, subject to approval of the Farm Credit Administration, shall determine the amount, maturities, rates of interest, terms, and conditions of participation by the several banks in each issue of joint, consolidated, or System-wide obligations."

must be revised to require that all information provided under the agreement plus committee minutes be retained by the Funding Corporation. In addition to giving the Funding Corporation access to all information, this arrangement would facilitate review by FCA and FCSIC.

Our second concern relates to the change that would result in the decisionmaking group under the proposed agreement. The agreement would shift market access decisionmaking from the Funding Corporation Board to a decisionmaking group consisting of all banks not in category II or III. We believe that the interests of the System in terms of market access decisionmaking are already represented by the Funding Corporation Board. The Funding Corporation's Board is largely composed of System representatives; therefore, we believe it is unnecessary to change the decisionmaking dynamics. All but two of the board's voting directors are elected by the System banks. In addition, the board includes two outside directors, who could provide useful insights and bring objectivity to the board's deliberations.

In its comments, FCA noted that System banks are represented on the Funding Corporation Board on a rotational basis; thus, all banks are not directly represented. That is, although seven of the directors are elected by all of the banks, each bank does not get to elect a director from its district every term. This raises a concern, FCA stated, that weaker banks could be voting on market access while stronger banks might not be directly represented on the Funding Corporation Board. Therefore, FCA states, the proposed agreement's provision to exclude a troubled bank from decisionmaking has merit. The Funding Corporation directors have fiduciary responsibility to represent the interest of the System (i.e., not just their respective banks). However, we do recognize the practical limitations of this charge.

FCA noted that our observation on including the Funding Corporation's independent directors in the decisionmaking process seems to have merit. FCA addressed this issue in its required revisions to the proposed agreement. FCA will require an independent director to serve on the committee and as part of the decisionmaking group.

Our third concern involves any impairment to the authority of FCA and FCSIC and their being named as parties to the agreement. FCA and FCSIC have specific responsibilities and powers as the System's arm's-length regulator and insurer. Therefore, it would be inappropriate for them to enter into any arrangement that could limit their options in dealing with System

banks. FCA responded that it shares our concerns about the System's original request for it and FCSIC to become "formal parties" to the proposed agreement. FCSIC did not comment on this matter in its response to our draft. System and Funding Corporation officials state that the other parties to the proposed agreement have not insisted that FCA and FCSIC become parties. They are prepared to implement the proposed agreement without such an arrangement, provided FCA approves the terms of the proposed agreement. FCA, in its preliminary approval, included the removal of FCA and FCSIC as parties to the agreement as another required revision. FCA also required that the proposed agreement be revised to reflect that its approval in no way restricts the statutory rights of FCSIC or FCA. FCA included some specific requirements that are aimed at preventing any misunderstandings about the authority of FCA and FCSIC compared with any provisions of the final Market Access Agreement. For example, FCA required that the proposed agreement be revised to provide that no bank can challenge a receivership or conservatorship on the grounds that market access had not been restricted or denied pursuant to the agreement. FCA also required that the proposed agreement be revised to clarify FCA's authority to veto (within 30 days) any decision to deny a bank market access.

The required revisions FCA specified in its preliminary approval of the proposed agreement address our three areas of concern about the proposed agreement. Although FCA required several changes relating to ensuring its own and FCSIC's regulatory powers, we continue to emphasize that before granting its final approval FCA must ensure its powers and those of FCSIC will not be impaired.

Conclusions

The changes in oversight created by the expiration of the Assistance Board, the activation of FCSIC, and the evolving role of the Funding Corporation should not threaten the safety and soundness of the System. FCA identifies deficiencies through its examinations and monitoring and takes strong enforcement action when needed. The Assistance Board provided a business-focused monitoring perspective that differed from FCA's safety and soundness and regulatory compliance focus. FCSIC plans to monitor assisted banks in ways that are similar to the Assistance Board, but we could not assess FCSIC's work because it assumed the responsibility so recently.

FCA has coordinated with the Assistance Board, the Funding Corporation, and FCSIC to minimize any adverse effects of their overlapping activities. As

we discussed in this chapter and chapter 2, FCA originates its own monitoring and examination information and only uses information obtained from the Funding Corporation to supplement its efforts. We found several of the same areas were monitored by FCA, the Assistance Board, and the Funding Corporation, but all of them had different incentives in their monitoring and all relied on FCA's assessment of institutions' compliance with regulations. The various levels and types of oversight of these entities complemented FCA's and provided additional input to the System during this critical time of recovery from the 1980s crisis. Although monitoring activities overlap, we found no indication that this situation hampers FCA's ability to regulate the System.

FCSIC became operational so recently that we were only able to review its plans for coordinating with FCA. If implemented as planned, they should be adequate to prevent unnecessary duplication. We found that FCSIC is not statutorily required to have its financial statements independently audited, although its current policy requires it. In addition, we found that although FCSIC is subject to some outside oversight, it is not subject to the oversight of an inspector general. However, the insurers of banks, thrifts, and credit unions are. Planned reviews of FCSIC will not evaluate its decisions to liquidate a System institution or provide assistance. FCSIC's mission is vital to ensuring that the System meets its financial obligations to investors and does not require government assistance in the future as it did in the past. We believe that FCSIC should have the benefits of the permanent, independent oversight of all its operations that an inspector general would provide.

The Funding Corporation monitors the condition of banks through MARAP and is required to establish conditions of participation for System-wide debt subject to FCA's approval. Because FCA has final approval authority on all debt issuances, it must ensure that any market access program adequately protects the System from weak banks. In February 1993, the System submitted to FCA a proposed Market Access Agreement that established conditions of market participation. This draft agreement proposed that market access, monitoring, and decisionmaking functions be performed by a System committee with the involvement of all healthy banks. FCA's preliminary approval outlined several conditions that must be met before final approval is granted. We believe it is appropriate for the System to exert self-discipline, barring any negative effect on the powers of FCA or FCSIC. The required revisions FCA specified in its preliminary approval of the proposed agreement addressed our concerns about the proposed agreement.

FCA required appropriate changes to ensure its own and FCSIC's regulatory powers are not impaired. However, if the System accepts FCA's requirements to have the boards of directors of all System banks approve the agreement and to publish the proposed agreement for public comment, it is possible the agreement would be revised further. Therefore, before granting its final approval to the proposed agreement FCA must again ensure that its powers and those of FCSIC will not be impaired.

Recommendations to Congress

We recommend that FCSIC be subject to oversight of the FCA Inspector General and be required to have an annual independent audit of its financial statements to ensure that all aspects of its operations are reviewed.

Recommendations to FCA

In considering the proposed Market Access Agreement or similar proposals for approval, FCA should ensure its regulatory powers, including its duty to approve market access decisions, and FCSIC's authority, will not be impaired.

Agency Comments

FCSIC did not object to our recommendation to Congress, although it expressed concerns about any increase in audit costs and any limits on obtaining special audit expertise. We address these issues on page 118. FCA did not comment on this recommendation, and the System concurred with it.

The System took strong exception to our draft recommendation that FCA require the Funding Corporation to retain its ability to monitor and analyze the financial condition of System institutions and that its board be responsible for market access decisions subject to FCA's approval. FCA pointed out several positive aspects of the System plan to shift monitoring and market access decisionmaking functions to a committee of the System and the System banks as provided in the proposed Market Access Agreement. Subsequently, FCA tentatively approved the agreement contingent on several changes that addressed our concerns. FCSIC stated that the proposed agreement was consistent with the Funding Corporation's ability to monitor System institutions and that it would not erode the Funding Corporation's market access responsibilities. On the basis of FCA's action and the comments received, we withdrew our draft recommendation. We incorporated FCA's, the System's, and FCSIC's

comments on pages 124 through 127. The full text of their comments and our responses are found in appendixes IV, V, and VI, respectively.

FCBs Oversee Associations' Operations

Before 1986, FCA delegated the examination of associations to the banks. After the 1985 amendments to the Farm Credit Act, FCA could no longer delegate this responsibility. Also, it received new enforcement powers and became an arm's-length regulator of the System. Nevertheless, FCBs continue to "supervise" associations as authorized by law.[1] For decades, System banks have been responsible for most aspects of association operations. Because the law grants both FCA and banks the authority to oversee associations, some of their activities overlap, although they have different reasons for their oversight. We did not find evidence that this overlap impairs FCA's ability to regulate the System's safety and soundness. According to FCA and bank officials, they regularly share and use each other's information. However, given the complex, decentralized structure of the System, potential for conflict exists. Yet, FCA clearly has the power necessary to ensure safety and soundness at both banks and associations.

Bank Oversight: An Historical Perspective

Legislation during the 1980s changed the way FCA regulates the System. Before the 1985 amendments, FCA was closely involved in the day-to-day operation of the System, but banks supervised association operations with little FCA involvement. FCA also relied heavily on the banks to examine associations. After the 1985 amendments, FCA was no longer able to delegate its examination authority to banks. FCA had to perform its own independent annual examinations of all System institutions, including associations. However, an FCA regulation (12 C.F.R. 614.4135), adopted in 1972 and still in force, requires banks to supervise association credit operations and take corrective actions when deficiencies occur.

As we discussed in chapter 1, the Agricultural Credit Act of 1987 made structural changes in the System by requiring the merger of all Federal Land Banks and Federal Intermediate Credit Banks of each district into a Farm Credit Bank for each respective district. Although the 1987 act is considered by FCA to promote more autonomous associations, it made few changes to the authorities that banks have over them. As in the 1971 act, banks continue to have the authority to control most aspects of association operations from salary scales to investing current funds. (See table 5.1 for a comparison of pre- and post-1987 bank oversight authorities.) The act did take away the banks' ability to remove association management (i.e., one of FCA's enforcement powers), but given the banks' other broad authorities, we believe they have other ways to influence association behavior.

[1]This chapter applies only to our five selected FCBs, not CoBank.

Table 5.1: Comparison of Some 1971 and 1987 Bank Supervisory Authorities Over Associations

Statutory authorities	1971	1987
Powers to[a]	FICB/ FLB	FCB
Approve the appointment and compensation of chief executive officer and salary scale of staff	yes	yes
Delegate power to associations	yes	yes
Establish lending standards for associations	yes	yes
Supervise associations	yes	yes
Approve alternative funding sources	yes	yes
Approve association investments	yes	yes
Approve merger plans	yes	yes
Approve service charges	yes[b]	yes
Approve loss-sharing agreements	yes	yes
Prescribe amounts held as surplus by associations	yes[c]	yes
Approve dividends	yes[b]	no
Remove association management	yes[d]	no

[a]This is not an exhaustive list of bank authorities over associations.

[b]FLB only.

[c]FICB only.

[d]While banks did not have specific statutory authority to remove association management, they were able to do so. A 1987 act provision generally prohibits bank removal of any association director or officer.

Banks continue to prepare financial statements on a combined basis, i.e., with their associations. Additionally, CIPA, which established the performance standards for the banks, is based on combined bank and association information derived largely from these financial statements. The Assistance Board also operated through the banks to address association issues. It provided assistance to associations through banks and also allowed banks to ensure associations' compliance with the assistance agreement.

In 1991, FCA recommended that Congress restrict a bank's supervisory authorities to those associations that have not qualified to become direct lenders. "The supervisory authority of banks over associations," FCA stated, "circumscribes an association's control over its own activities and also clouds the issue of association accountability." A top FCA official told us FCA has never formally taken the position that bank supervision is unnecessary. FCA emphasized that banks and their boards continue to have

the fiduciary responsibility to properly administer their direct loans in a safe and sound manner. Bank officials are opposed to limiting their ability to supervise associations, and they continue to oversee associations closely.

Bank Powers Over Associations

Banks can assert control over associations through existing statutes, regulations, and contracts. However, the extent to which banks exercise their powers varies by district. These powers range from general supervision to specific approval authorities. Bank supervision, which can include reviews, monitoring activities, or substantially managing associations, varies among the banks. Our work focused on the banks' reviewing and monitoring activities, referred to as bank oversight, because this aspect of bank supervision most closely parallels FCA's oversight activities as the regulator of the System.

The law states that associations are subject to supervision by the bank as well as regulation by FCA. Banks have specific powers to approve many important corporate policies, such as salaries for association management and staff, the appointment of chief executive officers, the use of alternative funding sources,[2] and merger plans. Banks have the power to delegate functions to associations as they deem appropriate. Banks use this delegation to reward associations that perform well with less bank oversight.

Banks have additional regulatory authorities regarding associations, such as evaluation of association creditworthiness, supervision of credit operations, and assisting with and supervising credit training for association employees (e.g., credit administration training, loan servicing training). FCA monitors the banks' oversight of their district associations as part of its bank examinations. Banks establish additional powers over associations through contracts. FCA regulations require that banks have general financing agreements (GFA) with certain associations. A GFA is essentially a contract that establishes the terms and conditions (e.g., covenants, defaults, default remedies) of the funding arrangement between banks and their direct-lending associations. Because only banks are authorized to issue System-wide debt, associations rely on their district banks for funding. Historically, GFAs have contained many supervisory provisions, and most bank officials continue to consider the GFA instrumental in their oversight of association operations.

[2]Alternative funding sources are commercial banks or other financial institutions.

Although a System bank and its associations are chartered as separate entities, their relationship is in some ways similar to a commercial bank's relationship with its branches. The banks create lending and credit standards for their districts and monitor association adherence to these standards. All of the banks we reviewed set prior approval levels, which require associations to obtain bank approval to make loans above the limit. The bank-association resemblance to a commercial bank-branch relationship is clearest in districts where banks exert a substantial amount of control over association operations. In one such district, the bank and associations function essentially as one entity with numerous branches throughout the district. However, unlike a commercial bank with branches, FCBS are owned by their member-borrowers. Member-borrowers elect directors to the banks' boards, who are responsible for the banks' management.

Bank Oversight Activities

Although the 1987 statutory authority has not substantially changed the banks' powers over associations, most bank officials we interviewed agreed that their exercise of these powers is changing.[3] One bank official described the change as giving associations a "helping hand" instead of telling them what to do. Another official described the relationship as previously being 80-percent paternalistic and 20-percent contractual with that orientation now reversed. Some bank officials characterize their new relationship as "debtor-creditor," although this erroneously implies an independently negotiated funding arrangement. In the System, although GFAS may be negotiated, there is no independent funding relationship between banks and associations.

The funding relationship in the System is unlike the classical debtor-creditor arrangement because banks have authorities that most creditors do not have. These authorities include the ability to set management salaries, establish or approve policies and procedures, and disapprove alternative funding sources. Associations cannot freely borrow and banks cannot call an association's loan without FCA's approval. Thus, banks lack the authority most creditors have to terminate or call a loan. Likewise, associations cannot seek other sources of funding without the bank's approval. Banks also have access to FCA's examination reports of associations and are criticized by FCA when their oversight activities fail to adequately affect association performance.

[3]Our discussion applies only to the five FCBs we reviewed; our findings are not generalizable to all FCBs.

Although a classical debtor-creditor relationship is impossible in the System, the existing relationship is further complicated by certain district structures. A bank with few associations cannot function solely as a creditor because the interests of the bank and the association are intertwined. For example, a bank that has only one association is dependent on the performance of that association. If the association has problems, the bank will have problems. This is less true of a bank that has many associations. However, if enough of the associations have problems, the bank will also.

Bank documents we reviewed indicated limited involvement in the daily operations of their associations. However, bank officials described their efforts in providing direction and guidance to associations through policies, procedures, and training programs. Additionally, banks perform extensive monitoring and reviews and have association rating programs that are similar to FCA's.

Banks determine the creditworthiness of associations and ensure the soundness of their own wholesale loan portfolios through periodically reviewing and monitoring association operations. In most districts we reviewed, the extent of bank monitoring and the scope of the reviews depended on the condition of the association. Unlike most creditors, the banks often performed on-site reviews of association operations similar to FCA examinations. The following sections illustrate how banks establish standards and review and monitor district associations.

Banks Monitor Compliance With Financing Agreements and Business Plans

Banks use financing agreements and association business plans to set performance standards. Bank officials consider financing agreements to be the key elements in their bank oversight. For three of the five FCBs we reviewed, a GFA established performance standards that must be met by associations. Banks' monitoring of the GFA varies from very detailed (e.g., assigning specific individuals to monitor each provision of the agreement) to general (e.g., monitoring overall compliance with the agreement through a particular section of the bank's staff, such as the credit department).

Three of the five FCBs we reviewed told us they use the associations' business plans to establish performance benchmarks. Monitoring how an association performs in relation to its business plan projections helps banks ensure that associations are performing adequately. One of the

banks develops business plans with its associations, while others merely approve association-developed business plans.

Review Programs Vary, but All Are Extensive

All of the banks we reviewed have association review programs that include on-site and off-site activities. On-site reviews focus on creditworthiness but often cover other areas examined by FCA, such as borrower rights, lending practices, operations, internal controls, and compliance with terms of the bank's GFA. The scope of these reviews often varies depending on the condition of the association. The banks also perform additional off-site monitoring. Each of the banks wrote a report of its findings, and some made recommendations to association boards and/or management.

Banks may use information obtained through an association's own internal credit review program to augment their oversight efforts. FCA regulations require that all of the System institutions, including associations, review and assess the quality of their assets. Areas covered include loan standards, asset classification quality standards, standards for assessing credit administration, and training standards. The reliability of these reviews is tested by the banks as part of their oversight. Historically, some banks conducted this internal credit review for associations. Today, the association or a consultant performs some of these reviews. This helps associations identify their own weaknesses and strengthen their internal controls.

In addition to examination by external consultants, the System banks use FCA examination reports as additional monitoring tools to gauge association performance. According to one bank document, a bank's review should identify any weaknesses identified by FCA. Likewise, a bank official from another district told us that there has been nothing critical in FCA's exams that the banks do not find themselves. (We address this overlap later in the chapter.) Using FCA examinations helps banks ensure that associations are properly addressing the regulator's concerns. Some banks also monitor association compliance with FCA recommendations and enforcement actions during their reviews.

Banks Assign Ratings to Associations

Several banks use rating systems to monitor and compare the performance of their district associations. These rating systems were either based on

FCA's five CAMEL categories or the CIPA model.[4] These banks use their ratings for various purposes, including monitoring performance, determining the appropriate level of oversight, and establishing the cost of funds for the associations. In general, we found that the banks shared association ratings with all of the associations in their district. Officials told us this pressures each association to improve its score in relation to its peers.

Opinions Vary on Banks' Abilities to Control Association Behavior

We found bank and FCA officials had varying opinions on the banks' abilities to control association behavior. Some bank officials believe that with GFAs and their statutory authority, banks have all the authority they need. Other bank officials disagreed. As examples of their lack of authority, these officials pointed to the elimination of their ability to remove association management and their inability to terminate an association's line of credit without FCA's approval. Some bank officials identified indirect means that can be used to influence the behavior of associations. For example, a bank can encourage mergers between associations or dictate so many restrictions and requirements that associations are compelled to comply with the bank's demands. These strictures include increasing reporting requirements and decreasing association prior approval levels.

In general, FCA officials believed banks have substantial authorities over associations. However, some FCA examiners disagreed, stating that the banks are "toothless" because they lack enforcement powers. We believe that although banks lack formal enforcement authorities, they have the leverage to persuade associations to change unacceptable behavior.

Banks have an array of sanctions to help achieve compliance with their financing agreements. They include terminating or capping the line of credit subject to FCA's approval, increasing oversight, increasing use of prior approvals, and taking possession of pledged collateral. FCA, concerned that banks could force associations into de facto liquidation, requires banks to notify it at least 60 days before any action is taken that would result in the liquidation of an association.[5]

[4]Unlike FCA's CAMEL ratings, the banks use pre-established weights for each of the five components of the rating.

[5]De facto liquidation refers to any action that would result in the liquidation of an institution.

Overlap Exists but Poses Few Conflicts

Given the banks' broad involvement in association operations and oversight, there is some overlap between their and FCA's activities. We did not find that the overlap impaired FCA's ability to regulate the System. Although some activities overlap, the banks and FCA have different reasons for their oversight. FCA's focus is ensuring safety and soundness and compliance with laws and regulations. The banks, although concerned about issues of safety and soundness, have a fundamental economic self-interest in monitoring their associations. This is because as banks move away from retail lending in many districts, they depend on association performance to ensure their own viability.

Much of the overlap is unavoidable because of the complex, decentralized structure of the System, but some FCA field offices and System banks try to minimize duplication through coordination. In addition, bank officials recognize FCA as the regulator with final authority.

The amount of coordination involved and FCA's use of bank information vary depending on FCA's confidence in the bank. Before starting an association examination, FCA examiners often contact the bank to find out if officials have any supervisory concerns. If FCA deems a bank's analyses reliable, it uses the bank-generated information to assist in scoping its examination. FCA sometimes relies on the bank- or association-generated credit reviews when sampling the loan portfolio after testing the reliability of that work. One FCA field office, for example, took less than a 1-percent sample of mortgage loans because it felt it could rely on the bank's review, which randomly selected 30 percent of the mortgage portfolio. In other districts, FCA still cites weaknesses that would reduce FCA's confidence in a bank's analysis. In one such district, FCA criticized the bank's oversight of associations in its examination and concluded that the bank overstated the quality of association credit administration. FCA advised the bank's board to "ensure internal audit and credit review processes are complete and convey the appropriate conclusions."

Often, bank oversight appears to complement FCA's oversight. For example, one bank penalized several associations by lowering their lines of credit based on deficiencies cited in FCA examinations. Another bank required action plans from associations that addressed how associations planned to correct FCA-cited deficiencies.

Bank and FCA officials told us that associations sometimes complain about dual oversight by the bank and FCA. We found instances of bank and FCA audits occurring within days or weeks of each other. An FCA official

suggested that this is sometimes done consciously when the field office examiners want to test the bank's findings.

Potential for Conflict Exists

Although we found no significant conflicts between FCA and bank oversight, the potential for conflict exists. FCA and the banks provide feedback to associations about their performance that, if conflicting, could hamper corrective action. If FCA and a bank had similar findings as to weaknesses but different priorities for addressing them, this could also send mixed messages to the associations and slow improvements. FCA believes bank supervision obscures association accountability because associations can argue that they operate under the direction of their banks and depend on the bank to alert them to problems. Since banks and FCA have overlapping oversight responsibilities, there will always be the potential for conflict.

We reviewed 19 judgmentally selected associations from 3 of the 5 FCBS we reviewed. The selection was based on asset size, FCA's CAMEL rating, the bank's rating, and type of association. We found that while FCA's scope tends to be broader than the banks', both often cover many of the same areas. With few minor exceptions, we found banks generally have findings consistent with FCA's. We found cases in which FCA and one bank occasionally differed over views on association performance in areas such as standards of conduct and management, with FCA tending to find more deficiencies. We also identified instances in which other banks found problems that were not addressed in the FCA examination report, although these problems were minor. In selected issue areas, we also reviewed bank policies and procedures, compared them to the applicable laws and regulations, and found no substantial conflicts that would hamper FCA's regulation.[6]

Conclusions

FCA became an arm's-length regulator of the System in 1985, but the law still gives banks broad authority to "supervise" their associations. Banks fulfill their oversight roles in different ways depending on the number of associations in their districts, their financial condition, management's and the bank board's philosophy, and other factors. Bank-association relationships are changing. Although banks continue to monitor association activities closely, most strive for a debtor-creditor-type relationship that would involve little bank involvement in association

[6]Selected areas included capital adequacy, internal controls, disclosure to shareholders, regulatory reporting, insider lending, conduct, lending practices and credit administration, and borrower rights.

operations. FCA recognizes that a true debtor-creditor relationship is not possible because of the interdependency of the banks and associations. However, in certain districts where there are one or few associations, a debtor-creditor-type relationship cannot even be approximated because bank and association viability are indistinguishable.

We found few conflicts in the messages that banks and FCA conveyed to associations. On the contrary, their findings were generally consistent, and their recommendations for improvements were also similar. FCA uses the results of bank oversight activities when they are reliable. Some bank activities complement FCA's, and one bank even imposed sanctions against its associations on the basis of FCA's findings. FCA has full regulatory authority to examine, regulate, and take enforcement actions against both banks and associations.

Given the complex, decentralized structure of the System, the potential exists for conflict between FCA's and a bank's messages to an association. However, FCA clearly has the power to resolve any conflict by requiring any corrective action needed at either or both institutions.

FCA's Customized Loan Portfolio Reviews Can Be Enhanced With Other Sampling Methods

The adequacy of a loan portfolio review depends on many factors, such as the method for selecting which types of loans to review, the proportion of each loan type reviewed, the reliability of the bank's loan classifications, and the nature and extent of problems identified. The loan review should also be evaluated in conjunction with the overall quality and frequency of the examination and monitoring effort. FCA, for example, examines System banks every year and monitors them monthly. The banks in our sample were receiving additional scrutiny because they were all under enforcement actions at some time between 1989 and 1991. In addition, the three assisted banks were being monitored by the Assistance Board.

The percentage of the portfolios and the proportion of each loan type that examiners reviewed in 1991 varied. Within the framework of FCA guidance and with supervisory approval of their examinations plans, examiners used their judgment in selecting loans to review. In loan categories that examiners judged to have higher risk, we believe the percentages of dollar volume they sampled were high enough to give examiners confidence that the risk of error in the unreviewed portion would be immaterial. In categories they judged to have low risk, such as mortgage loans, examiners took small, nonrandom samples, which did not provide a representative view of this loan category. We suggest that examiners use random rather than judgmental samples when reviewing small portions of a portfolio.

Examiners Judgmentally Select Loans and Target to Risks

FCA does not require examiners to review a specific proportion of the total loan portfolio or of any type of loan.[1] Nor does it require using any one method for selecting loans. In keeping with the customized nature of FCA examinations, examiners tailor the loan sample to each institution. FCA guidance suggests that reviews begin with loans in the highest risk categories and progress toward the less risky ones. FCA officials told us examiners generally review a combination of large, high-risk, and new loans.

We asked FCA to provide specific information for the six banks we reviewed on the types of loans reviewed in the 1991 examinations and how examiners selected them. Without exception, the loans were judgmentally selected. Examiners chose loans from virtually all categories in the portfolios (e.g., loans to direct lender associations, mortgage loans,

[1]Loans are reviewed for several purposes: to check the accuracy of the bank's classification, to review credit quality, and to determine compliance with internal controls or various regulations. When reviewing loans to determine compliance with regulations, such as borrower rights, examiners must select appropriate loans, such as restructured loans.

participation loans) but reviewed a larger proportion of the dollar amounts of the loans in the high-risk categories and a smaller proportion for the low-risk categories.

For example, FCA's review of 67 percent of one bank's $5 billion loan portfolio included all direct loans, all participation loans, 98 percent of loans to other financial institutions, and 63 percent of the bank's special assets pools.[2] Direct loans represented 57 percent of the bank's total portfolio, and 74 percent of them were adversely classified. The special assets pool represented only 6 percent of the portfolio, but 88 percent was adversely classified.

The small sample of mortgage loans examiners reviewed illustrates FCA's focus on risk. Mortgage loans represented 32 percent of the bank's portfolio, and examiners reviewed 8 percent of them. At least 77 percent of the mortgage loans were classified acceptable. The remainder had only minor problems but were not adversely classified. In addition, the examination manager told us he used FCA's recent examinations of the agent associations (i.e., Federal Land Bank Associations (FLBA) that service the bank's mortgage loans) to target loans from weaker FLBAS. This bank was under a cease and desist (C&D) order and FCA examiners and the Enforcement Division monitored it closely each month. FCA took additional enforcement action against this bank subsequent to the 1991 examination.

The following characteristics of the examiner's loan review of this bank were typical of FCA's work at the six banks we reviewed: (1) a judgmental sampling of high percentages of loan volume in categories was cited as high risk, (2) a judgmental sampling of low percentages of loan volume in mortgage loans was cited as low risk, and (3) examinations of the FLBAS servicing bank loans were used.

At two banks examiners reviewed all loans to direct lenders (representing 18 and 15 percent of the total portfolios) and took small samples (7 and 1 percent) of mortgage loans, which composed large portions of the total portfolios (82 and 84 percent, respectively). Again, FCA officials cited the lack of risk in the long-term mortgage loans and their overall acceptable

[2]The bank created special assets pools by buying or transferring adverse assets from district associations. The assets pools were to relieve the associations from the burden of managing the assets, improve their balance sheets, and apply special bank expertise to improve the assets' performance.

performance (79 and 81 percent) as justification.[3] In addition, FCA's classification of the loans sampled was virtually the same as that assigned by these banks. The bank where FCA sampled 7 percent of the mortgage loan portfolio had undergone an independent review of its loan portfolio in 1990 by an outside auditor. The auditor reviewed approximately 35 percent of the district's loan volume. (This district has only two associations and the bank holds 82 percent of the district's assets.) Thus, the FCA had additional knowledge about deficiencies in the portfolio and it was reasonable to concentrate examination resources elsewhere.

We asked the ranking FCA official responsible for the examination at the other bank where 1 percent of mortgage loan volume was reviewed why he thought the sample was appropriate. He said the mortgage loan portfolio contained long-term assets that were not renewed annually. He also said it was not useful to look at loans when they were performing because they presented little risk. Approximately 84 percent of this mortgage loan portfolio was performing. He said he generally focused on new, recently closed, or "serviced" loans (i.e., loans that underwent some change since the last examination, such as being restructured). He estimated the examination team reviewed 30 to 40 percent of the loans made or closed since the last examination; he could not provide an estimate for serviced loans. The sample was then drawn from the bank branch offices with the largest amounts of new, closed, and serviced loans. In addition, the FCA official told us the 1989 and 1990 examinations of the bank's FLBA provided a broader perspective on the condition of bank assets. Examiners reviewed a total of 12 percent of the FLBA's loans in those examinations.

In addition, the official said he emphasized selecting a scope of criticized loan assets that would equal or exceed 100 percent of capital and/or risk funds (i.e., permanent capital plus the allowance for losses on loans and acquired property), and the sample of the total portfolio exceeded both amounts. Within that framework, examiners used the following and other criteria to judgmentally select the loans:

- all insider loans;
- a minimum of 8 adversely classified loans with principal balances over $300,000 serviced by the Special Assets Division;
- all loans cited for credit administration weaknesses in the preceding examination;

[3]Regulations (12 C.F.R. 614.4210, 614.4050 (a)) provide for 10- to 40-year long-term real estate mortgage loans. They must be collateralized with a first lien, and the loan-to-value ratio must not exceed 85 percent unless the loan is government-guaranteed.

- a minimum of 24 restructured loans in accrual status;
- the 5 largest loans serviced by the branch, 5 largest country home loans, and 10 largest prior approved loans serviced by the branch;
- 6 new loans over $100,000 at the branches and 5 over $750,000 at the bank; and
- the 10 largest adversely classified loans.

A fourth bank evolved into a strict wholesale lender and 95 percent of its portfolio were loans to direct lenders; FCA reviewed all of them. The remaining 5 percent were participation loans and examiners reviewed all of them.

The portfolio of the fifth bank—one of the banks for cooperatives—comprised domestic and international loans (71 and 29 percent, respectively). FCA reviewed 42 percent of the dollar volume of the domestic loans and 84 percent of the dollar volume of the international loans. It reviewed all insider loans, all criticized loans over $5 million, all acceptable loans over $10 million, loans criticized by the bank's internal quality review, loans with credit or performance changes since the last examination, and others. Approximately 90 percent of the international loans were government-guaranteed.

At the sixth bank, FCA reviewed 100 percent of the direct loans, which represented 47 percent of the portfolio. FCA reviewed less than 1 percent of the mortgage loan portfolio, which represented the balance (52 percent) of the portfolio. The examiner told us the mortgage sample represented 50 percent of the new loan transactions in 1991. In addition, he explained that FCA relied on the work of the bank's internal audit office and its credit review program, which reviewed a random, modified sample of approximately 30 percent of the mortgage loan portfolio. FCA examiners reviewed the work of the internal audit office in 1991 and the 2 preceding years and found it reliable. We did not assess the adequacy of those reviews. If FCA's reviews of the internal audit function and the internal credit review program were adequate, then it would be appropriate for examiners to rely on that work.

Large Judgmental Samples Can Be Adequate but Small Samples Should Be Randomly Selected

Judgmental (nonrandom) samples may not be representative of the unsampled portion of the population and, if so, cannot provide a basis for conclusions on that unreviewed portion. However, a judgmental sample can be acceptable if it includes enough loans so that any error in the unreviewed portion of the portfolio is immaterial. To achieve this result

using judgmental sampling requires reviewing a very large dollar amount of loans. FCA took this sampling approach in loan categories other than mortgage loans at the six banks we reviewed. We do not take issue with FCA's practice of reviewing large portions of loan categories it has determined are high risk.

FCA examiners also judgmentally selected mortgage loans for review. Because FCA regards mortgage loans as low risk and examiners relied on the work of outside auditors, a bank's internal credit reviews, or its own FLBA examinations, examiners reviewed small portions of this loan category even when it represented a large portion of a bank's total portfolio. For example, mortgage loans at one bank were 32 percent of the total dollar amount of its loan portfolio. The total number of mortgage loans was 9,323, and examiners judgmentally selected 184 to review, which represented 8 percent of the dollar amount of mortgage loans. We do not question FCA's judgment about the perceived risk of these loans or the appropriateness of relying on the work of others when examiners find it acceptable. We believe, however, that randomly selecting the loans would provide examiners with an unbiased, representative view of the portfolio without requiring additional examination resources. Examiners could stratify the mortgage portfolio by size and other characteristics relevant to the review. Based on their judgment about risk, examiners might review small numbers of randomly selected loans of a certain type they regard as lowest risk (perhaps those classified as acceptable) but larger numbers of types they believe pose higher risk (perhaps loans to new farmers).

Summary of FCA Enforcement Powers

The Farm Credit Amendments Act of 1985 provided FCA with enforcement powers similar to those of other federal financial regulatory agencies. FCA can

- issue C&D orders (including temporary orders),
- suspend or remove directors and officers (and those charged with felonies),
- assess civil money penalties, and
- appoint conservators and receivers.

FCA, like other regulators, takes additional enforcement actions to ensure safety and soundness in the System. These actions include getting institutions to sign agreements and conditions of merger or reorganization, and issuing supervisory letters.

C&D Orders

A C&D order can be served on institutions and individuals when severe problems exist and when FCA is not confident that management can or will take the necessary steps for corrective action. The Farm Credit Act, as amended, provides for a C&D order when an institution or individual is engaging or is about to engage in unsafe and unsound practices or has violated or is violating any law, rule, or regulation. The C&D order specifies actions to correct the unsafe or unsound practices and requires that violations or unsafe or unsound activities stop. A C&D proceeding begins with a notice of charges that specifies the allegations of unsafe or unsound practices and/or any violations of law and regulations. The institution's board can either consent to the C&D order or answer the notice of charges within a certain period and then proceed to a hearing. If an institution does not comply with a C&D order, FCA can seek enforcement through federal district court. FCA also has the right to assess civil money penalties for violations.

Temporary C&D Orders

A temporary C&D order can be issued to immediately address violations or unsafe and unsound practices that are likely to cause insolvency, seriously weaken the institution or its earnings, or seriously prejudice the interests of System investors. Unless the temporary C&D order is set aside by a court order, it remains in place until the effective date of a C&D order or the dismissal of the notice of charges.

Suspension or Removal of Directors or Officers

FCA can initiate the removal of a director, officer, or other person when it determines that a violation of a law or regulation or of a final C&D order has occurred, or that unsafe and unsound practices were used or there has been a breach of fiduciary duty. In addition, FCA must determine that the institution has or will probably suffer

- substantial financial loss or other damage; or
- the person has received financial gain; or
- the interest of investors or shareholders in System obligations could be seriously prejudiced; and
- the violation, practice, or breach of fiduciary duty is one involving personal dishonesty or demonstrated willful or continuing disregard for the safety and soundness of the institution.

Under these circumstances, financial loss or damage could or has occurred, affecting the interests of the shareholders and investors in the System. To protect an institution, FCA is able to suspend the participation of an individual pending the completion of a removal action. Once in place, a removal or suspension order prohibits the individual from participating in any manner in the affairs of the institution. FCA can also suspend or remove an individual charged with or convicted of a felony if the individual's continued involvement in the institution threatens its interests. The FCA chairman can appoint individuals to the board of directors for a System institution if, due to removal or suspension, there is less than a quorum. The appointments would be temporary, until new directors are duly elected and take office.

Civil Money Penalties

FCA can assess civil money penalties against an individual or institution for violating a C&D order, laws, or regulations. The law provides for penalties of up to $1,000 a day for violations of a C&D order and up to $500 a day for violations of law or regulations. Before determining whether to assess a civil money penalty, by law FCA must notify the institution or individual to be assessed and solicit information. The law also provides an opportunity for a hearing by FCA at which the assessed individual or institution can submit relevant information addressing the grounds of the violation. FCA must review this information, then notify the individual or institution whether a penalty will be assessed. Its decision is subject to court review.

Appointment of Conservators and Receivers

The law provides for FCA to appoint a conservator or receiver for a System institution if one or more of the following conditions exist:

- The institution is insolvent.
- Earnings are reduced or impaired due to violations of law, rules, or regulations or to any unsafe or unsound practice.
- The institution is in an unsafe or unsound condition to conduct business.
- A deliberate violation of a C&D order has occurred.
- The institution has concealed or refuses to submit documents for review by authorized agents of FCA.
- The institution is unable to make a timely payment of principal or interest on any insured obligation issued by the institution.

As of January 6, 1993, FCA must appoint FCSIC as the conservator or receiver for System institutions; previously, it could appoint other entities. Under regulations FCA approved in October 1992, FCA will have less supervisory involvement with institutions placed in conservatorship and receivership. For example, FCA prior approvals of conservator or receiver actions will not be required. Institutions under receivership will no longer be required to be examined annually by FCA, but an annual audit with a report that will be made available to stockholders and the public will be required. The charters of institutions placed in receivership may be canceled by FCA, and FCSIC will succeed automatically to the rights of the institution.

Agreements

When an institution's problems are serious but not at the level required for a C&D order, FCA can call on an institution to agree to take remedial actions to correct specified problems. According to FCA, officials of such institutions have demonstrated an ability and willingness to address the requirements of the agreement. If an institution violates or fails to execute the written agreement, FCA can proceed to issue a C&D order.

Conditions of Merger/ Reorganization

FCA developed the conditions of merger/reorganization in response to the structural changes required and permitted under the 1987 act, according to FCA officials (see ch. 1), to ensure that enforcement actions in place at an institution were enforceable against and appropriate for newly created entities after a merger or reorganization. The condition documents, much like a C&D order, specify the allegations of unsafe or unsound practices and/or any violations of law or regulations and state requirements for corrective action.

Supervisory Letters

FCA issues supervisory letters to an institution when it wants to call attention to problems that are serious but not severe enough to warrant a stronger action, such as an agreement or a C&D order. Such letters are directed to board chairmen and are usually signed by the chief of FCA's Enforcement Division. FCA considers these letters an informal enforcement action; all other actions are considered formal. Such letters are also issued to institutions that are already under another enforcement action. These follow-up supervisory letters are usually issued after an examination, and they highlight deficiencies the institution must address and acknowledge any progress the institution has made. Sometimes, FCA uses them to modify an existing C&D order, agreement, or conditions of merger or consolidation.

Summary of Problems and Enforcement Activity at One Problem Bank

The problems of one of the six banks we reviewed (Bank F) have persisted and illustrate how the resolution of a System institution's problems can be even more troublesome when a bank's board of directors and management do not agree that FCA's actions are appropriate. Thus, this case study shows the limits of FCA's power to change bank behavior. The power ultimately rests with the bank's board of directors and management. FCA took appropriate, forceful action against this bank in a timely manner. However, bank management was slow to respond, and the bank assumed additional risks because of its relationship to its associations. In addition, the bank district's economic health was challenged by bad weather and volatile crop and real estate prices. By 1992, however, bank management had changed, and the bank had begun to make progress in addressing its problems.

Problem Assets Poorly Underwritten

FCA considered excessive high-risk assets and ineffective management to be the primary causes of the bank's problems. According to examiners, the difficulties the bank faced in improving its assets were illustrated by a number of problematic loans totaling $90 million that were made to one borrower. These loans also illustrate the difficulty FCA faced in prompting improvements at this bank. Problem assets, especially when poorly underwritten, cannot be resolved quickly. Examiners transferred the loans to substandard/nonaccrual after the September 1989 examination. Although the bank reported the loans were well-secured, examiners found their collateral values to be "optimistic" and said the loans were poorly administered, especially given their size and potential effect on the bank. The bank also failed to recognize the borrower's management deficiencies, which had been evidenced by poor business decisions.

The loans, which were made between 1984 and 1987, financed an integrated, commodity-farming, cattle-raising, and processing operation. In 1989, examiners reported the collateral value of the loans was high because appraised real estate values were based on the business being a "going concern." In reality, it was in the process of liquidation. In fact, it had been losing $1 million per month for over 2 years. In the 13 months before the 1989 examination, the appraisal had been increased 28 percent with no apparent reason to warrant the increase.

During most of the 1989 to 1991 period, bank officials maintained they would not take losses on these loans because the collateral—primarily land—was valuable. They believed that the manager of the business would sell collateral if it needed to do so and pay off the loans. In 1990, the bank,

at FCA's urging, took title to the real estate collateral underlying the loans. The bank placed a manager on site and contracted for an aggressive marketing program to sell the properties. Problems related to zoning, possible hazardous waste, and prior contractual obligations slowed the selling process. As of March 1993, the business was still being liquidated, and FCA estimated the loss to the bank at about $13 million.

Bank's Lax Oversight of Associations and Willingness to Accept Risks Compounded Its Problems

Examiners focused on underlying causes of the bank's high percentage of adversely classified and nonperforming assets in the 1990 examination: poor credit administration among associations and the bank's failure to ensure improvements. Over 60 percent of the loans to direct lenders were adversely classified in 1990; this amount increased to 70 percent in 1991 and 90 percent in 1992. By October 1992, FCA had taken enforcement actions against 88 percent of the district's associations. When loans made by associations are poor, then a bank's direct loan to an association (which funds the association's lending) is at risk. Bank management objected to being criticized for the performance of the direct lending associations, saying it had limited control over them. But FCA maintained the bank could directly affect association performance through requirements for funding, limits on prior approval of loans, training, and districtwide policies and procedures. FCA was particularly concerned about direct lender performance because the bank's mortgage portfolio was being sold to these associations as the bank "downstreamed" (transferred loans to its associations) its assets to become a wholesale lender, as encouraged by the 1987 act. (See discussion in ch. 1.)

In the 1989 C&D order, FCA required the bank to develop action plans for improving the quality of the direct loans. Examiners found the plans provided direction and time frames to the associations but criticized the bank in 1990 for not including requirements or incentives in the general financing agreements to improve performance. By 1992, however, the bank had established new association rating and differential interest rate pricing programs. FCA believes these programs should improve direct loan quality if the bank effectively implements and enforces them.

The bank was also directly affected by its lax oversight when it assumed responsibility for some nonperforming loans from associations. As part of its effort to improve asset quality and the financial condition of some associations, the bank bought and managed bad assets. The bank created several special assets pools and had all associations in the district share the expenses and losses involved. Although the bank assumed this

additional risk, it passed the earnings from the pools to its associations, keeping its own capital low. FCA continued to criticize the bank for being inadequately capitalized given the risks in its portfolio.

Bank Progress Was Slow; Management Was Ineffective; New Problems Emerged; and FCA Issued a New C&D Order

FCA examiners reported in late 1991 that the bank management's actions to comply with the 1989 C&D order had "yet to achieve the desired results and, in some areas, the level of compliance had deteriorated." While the requirements of subsequent follow-up supervisory letters were partially met, they had not yet resulted in measurable improvement in the bank's condition.

On the basis of the 1991 examination, FCA determined that the bank was not in substantial compliance with the 1989 C&D order. The bank's board and management had not provided the "appropriate level of direction, influence and control to effect necessary changes . . . ." The examination report, issued October 31, 1991, was highly critical of the bank's management and stated that fundamental and broad improvements were needed in areas such as leadership, delegation, and communication. FCA decided a new C&D order was needed to address continuing deficiencies and newly developing problems in the management of interest rate risk and standards of conduct.

Bank F's loan portfolio continued to deteriorate, which offset any improvements in adversely classified loans. Nonearning assets increased. Deterioration was evident in loans made by associations after FCA issued the 1989 C&D order. Interest rate risk also increased. Examiners noted some improvements but generally criticized new policies and control requirements. For example, FCA said numerous weaknesses existed in the new policies to control risk associated with increases in fixed-rate loan products. In the year before the June 1991 exam, the bank funded an increase (from $54 million to $293 million) in fixed-term mortgages with debt of similar maturities. FCA said management-prepared materials for the bank's board of directors did not adequately analyze the potential risk. The materials did not reflect likely events, such as increased prepayments of loans if interest rates dropped, that could burden the bank with improperly matched longer term bank debt.

Another new problem examiners identified in the 1991 examination was violations in the standards of conduct. Previously, FCA had identified only "technical weaknesses" in this area. Examiners found violations at both the bank and its associations and weaknesses in the bank's investigations

of possible conflicts at the associations. The bank's standards of conduct officer did not fully record, investigate, or follow up on conflict disclosures. FCA said the cause of this was poor personnel management within the bank.

The specific conduct problems examiners most often cited involved questions of preferential treatment, undisclosed business deals between employees and borrowers, and inappropriate use of inside information by association directors or employees. In the February 19, 1992, C&D order, FCA required the bank, within 45 days, to investigate and report on each actual or potential violation of standards of conduct examiners cited in the June 30, 1991, examination report. Within 85 days, the bank had to revise, adopt, and implement adequate policies and procedures to detect, prevent the recurrence of, and investigate potential violations. In the 1992 examination, FCA noted it was still finding violations at associations, which indicated "some district employees and directors continue to involve themselves and their institutions in potentially damaging circumstances."

Starting in 1989, FCA became increasingly critical of both the board of directors and management of the bank. In 1989, it credited the board and management with improving the bank's financial performance since the 1988 examination, but it said weaknesses remained due to breakdowns in controls. FCA examiners warned that the lack of adequate management controls could reverse the recent improvement. Again in 1990, the examiners acknowledged that management had taken positive steps to correct some problems but noted that asset quality and financial condition did not improve. FCA emphasized the critical nature of the bank's problems in a follow-up supervisory letter.

The 1992 C&D order required the board to have an outside consultant, approved by FCA, analyze and evaluate the work of the board and management with the goal of enhancing their effectiveness. The board had to respond to each conclusion and recommendation from the consultant and explain to FCA why any actions the board planned to take differed from those recommended by the consultant. The consultant's May 1992 report was not made public, but FCA officials said its observations on board and management weakness were much the same as their own. A new board chairperson was elected in January 1992. The chief executive officer, who had served since 1988, left the bank in July 1992. Although FCA had no formal role in the departures of those officials, FCA had consistently emphasized to the board that stronger leadership was needed.

This case study illustrates that although FCA has adequate enforcement powers and uses the most forceful enforcement action available, an uncooperative bank board and management can retard progress toward resolving problems. Without the cooperation of the board of directors and management, FCA's powers to achieve improvements at any System institution are limited. A board of directors and the management it supervises are ultimately accountable for the performance and safety and soundness of their institutions.

FCA, like other government regulators, must take enforcement action when safety and soundness are threatened. FCA can insist, as it did at Bank F, that violations of law and regulations cease and that weaknesses causing the problems be addressed through changes in policy and procedure. FCA cannot, however, simply take over an institution's daily operations. Only if FCA and the directors fundamentally agree on the problems and plans for solutions will resolution be smooth and swift. If, as in the case of Bank F, that agreement is not in place, progress is much more problematic.

Comments From the Farm Credit Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Farm Credit Administration

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August 16, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

Thank you for the opportunity to provide comments on the General Accounting Office's (GAO) draft report entitled "Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems." This letter represents the Farm Credit Administration's (FCA) response to the draft report. This letter does not address the recommendations pertaining to the Farm Credit System Insurance Corporation (FCSIC) since FCSIC will prepare a separate response for your consideration.

The FCA was pleased with the comprehensiveness of the review and the thoroughness of the report. We support the overall conclusions and recommendations on the FCA examination and monitoring of Farm Credit System institutions and on the effectiveness of enforcement actions. In several instances, we have already taken actions toward implementation of the recommendations. However, we do have some suggestions and comments on a few of the recommendations which we would like you to consider.

In addition to the comments on specific recommendations, we have also enclosed for your consideration a list of editorial suggestions to clarify or update the body of the report.

GAO Recommendation

To enable FCA to effectively ensure the safety and soundness of the National Bank for Cooperatives, we recommend that Congress amend the 1987 Act to give FCA authority to set appropriate lending limits for this special bank.

FCA Comment

The FCA strongly supports this recommendation.

2

GAO Recommendation

Require examiners to make comprehensive reviews of all segments of the loan portfolio with random sampling used where appropriate.

FCA Comment

See comment 1.

We agree with the recommendation and believe that random sampling can be an effective method of reviewing a mortgage loan portfolio. It can be even more effective when used in conjunction with judgment sampling whereby the examiner relies on experience and knowledge to stratify the portfolio so that judgment is used in selecting loans for review in the areas in which risk has been identified.

We would prefer that the wording of the recommendation reference the risk-based approach to our examinations, which does not necessarily include a comprehensive review of all segments of the loan portfolio. Such comprehensive reviews may not be necessary when prior examinations and interim monitoring memoranda have concluded that internal controls are adequate, asset quality is strong, management of the institution is capable, and economic conditions have remained positive. Under these conditions, less than comprehensive reviews of the loan portfolio may be appropriate.

This risk-based approach to our examinations is also consistent with the change in the Farm Credit Bank and Association Safety and Soundness Act of 1992, which permitted FCA more flexibility in defining the scope of examinations.

GAO Recommendation

Adopt the proposed regulation limiting loans to one borrower to 20 percent of capital for all associations.

FCA Comment

See comment 2.

On July 15, 1993, the FCA Board adopted a final regulation limiting loans to one borrower to 25 percent of capital for all associations and Farm Credit Banks. This regulation becomes effective January 1, 1994.

GAO Recommendation

We recommend that FCA require that the Funding Corporation retain its ability to monitor and analyze the financial condition of System institutions and that its board be responsible for market access decisions subject to FCA's approval.

FCA Comment

See pp. 123-127.

The FCA Board has under active consideration the proposed Market Access Agreement (MAA) and the fundamental issues it raises. The agency shares your concerns about the System's original request for the FCA and the FCSIC to become formal parties to MAA. We note, however, that MAA, in certain respects, enhances the Funding Corporation's ability to monitor and analyze the financial condition of System institutions, because it results in an agreement by all banks to provide information through the Monitoring and Advisory Committee. This information is currently not consistently available under the existing Market Access and Risk Alert Program. Under MAA the determination of market access is primarily based on objective criteria as opposed to committee or board decisions. These criteria include capital percentages and CIPA scores. In its coordinating role, the Funding Corporation serves as the CIPA scorekeeper and further monitors and assesses System performance by maintaining combined financial statements.

See p. 126.

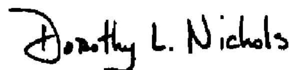
As proposed, MAA contemplates committee involvement only in the event of "forbearance" relative to the objective criteria. In this event, the committee would consider the request and forward a recommendation to the banks for a final decision. And, as you know, the System proposal does not contemplate the participation of the weaker financial institutions (category II and III as defined by MAA) in this decision making process. You have recommended that in lieu of an independent committee the Board of Directors of the Funding Corporation be responsible for market access decisions subject to FCA's approval. It should be pointed out that the banks of the System are represented on that board under a rotational agreement with not all of the banks being represented at any given time. This aspect of your recommendation raises the concern that the weaker banks could be voting on access while stronger institutions are frozen out of the process. However, the inclusion of independent directors in the decision making process, whatever that process may be, seems to have merit.

See pp. 124-125.

Finally, in considering this recommendation, it is important to note that although the Funding Corporation is federally chartered, it is owned by the System. Thus, the practical value of making the Funding Corporation responsible for market access recommendations as opposed to having the banks responsible is questionable.

Again, we appreciate the opportunity to respond to the draft report. If you would like to discuss the response or have any questions relating to it, please contact me at (703) 883-4000.

Sincerely,



Dorothy L. Nichols
Chief Operating Officer

Enclosures

The following are GAO's comments on the Farm Credit Administration's (FCA) August 16, 1993, letter.

GAO Comments

1. We clarified that our recommendation should be taken in the context of FCA's risk-based approach to examinations. As noted in our conclusions, FCA customizes its examinations and monitoring of System institutions. We believe it is appropriate for FCA to tailor its regulation of System institutions within the minimum standards set by regulation because of diversity in the System, the quality controls in place, and the extensive nature of FCA's oversight. (See p. 96.)

2. We amended the text to reflect FCA's new regulations and deleted the recommendation. (See pp. 72-73.)

Comments From the Farm Credit System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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MAXEY D. LOVE, JR.
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CHAIRMAN, EXECUTIVE COMMITTEE

September 1, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
General Accounting Office
Washington, DC 20548

Dear Mr. Finch:

We appreciate the opportunity to respond to the draft report entitled FARM CREDIT SYSTEM: Farm Credit Administration Effectively Addresses Identified Problems. The comments that follow are provided on behalf of the institutions of the Farm Credit System, including the Federal Farm Credit Banks Funding Corporation, and represent the collective views of those institutions.

Our response is divided into two parts. Attachment I is the System's response to the draft report's observations and recommendations concerning the Market Access Agreement and the Funding Corporation's role relative to denying or restricting market access. While there is much in the report with which we agree and we compliment the GAO on the work they have done, this is an area with which we take strong exception. Attachment II, on the other hand, contains additional System comments to the draft report's observations and recommendations unrelated to market access.

In addition, we note that CoBank -- National Bank for Cooperatives has separately filed, on its own behalf, comments that take strong exception to the draft report's recommendation that the Farm Credit Act be amended to permit FCA to set, by regulation, CoBank's lending limit. We expressly endorse those comments and incorporate them by reference as a part of this response.

THE FARM CREDIT SYSTEM

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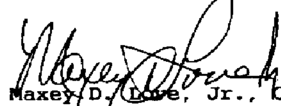
Once again, we appreciate this opportunity to respond to the draft report, and we trust that our response will be helpful as the GAO proceeds to finalize the report.

Very truly yours,



Maxey D. Love, Jr., Chairman
Presidents Planning Committee

Attachments (2)

cc: Members, Presidents Planning Committee

ATTACHMENT I

SYSTEM RESPONSE TO GAO'S COMMENTS CONCERNING THE MARKET ACCESS AGREEMENT

Basis and Benefits of the Market Access Agreement

See comment 1.

There appear to be several factors which the General Accounting Office (GAO) may not have fully considered in arriving at its preliminary recommendation that the Federal Farm Credit Banks Funding Corporation's (Funding Corporation) Board of Directors should be responsible for "market access" decisions, subject to the approval of the Farm Credit Administration (FCA), instead of allowing those decisions to be governed by the Market Access Agreement (Agreement), to which the Funding Corporation would be a party.

See comment 2.

First, it is not correct, as implied in the draft report, that the Agreement supplants the Funding Corporation's function under Section 4.9(b)(2) of the Farm Credit Act of 1971, as amended (Farm Credit Act), of determining the "conditions of participation" in the issuance of Systemwide debt securities. To the extent the Funding Corporation has such a function (an issue on which the parties to the Agreement are not in entire accord), the Agreement in fact is designed specially to fulfill, not supplant, it. In entering into the Agreement, the Funding Corporation will be expressly determining that (1) the Agreement's automatic trigger points for restricting or prohibiting a financially-troubled Bank's participation in the issuance of Systemwide debt securities and (2) the associated mechanism for granting exceptions in extraordinary cases constitute the "conditions of participation" the Funding Corporation finds appropriate. The Funding Corporation was an active participant in the process of arriving at these market-access restriction and prohibition trigger points; moreover, a number of the trigger points are based upon scores calculated under the financial-performance-scoring model of the Contractual Interbank Performance Agreement (CIPA), which the Funding Corporation also took a lead in developing. Furthermore, under the Agreement, the Funding Corporation will be an active member on the Monitoring and Advisory Committee (Committee) which will collect information on any financially-troubled Banks and will recommend to the other System Banks whether, in any particular case, a waiver of contractual terms should be granted (by a vote of 75% of all Banks other than the troubled Bank in question) to the automatic restriction or prohibition from participating in the issuance of Systemwide debt securities by a financially-troubled Bank otherwise resulting under the Agreement. Thus, participation on the Committee will afford the Funding Corporation ample opportunity to fully express its views, which would reflect its expertise in gauging market conditions and the expertise of its outside directors, about whether an exception should be granted.

See comment 3.

Second, the Funding Corporation's Board of Directors has been advised by its outside legal counsel that there is nothing in the Farm Credit Act, the legislative history of the relevant

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statutory provisions or the FCA's regulations precluding the establishment of conditions of participation through the mechanism of a contractual agreement, provided the contractual agreement is properly approved by the FCA in advance of its implementation. Further, the Funding Corporation's legal counsel is not aware of any other judicial authority which would preclude such a contractual agreement. (Separately, the System Banks have concluded they have specific independent authority under Section 4.2(d) of the Farm Credit Act to enter into the Agreement.) The Funding Corporation's Board of Directors also sought the advice of legal counsel as to what factors should be considered in determining whether, as a business matter, it should or could enter into the Agreement. These factors, which were discussed at length by the Board of Directors when it preliminarily reviewed the Agreement during February 1993, included the following:

(1) the similarities and differences between the Agreement and a revised market access program (which would replace the Funding Corporation's existing Market Access and Risk Alert Program (MARAP)) previously developed for submission to the FCA;

(2) the sufficiency of the approval by the FCA as contemplated by the Agreement and the enforceability of the Agreement;

(3) whether the Agreement would materially accomplish the objectives which the Funding Corporation's Board of Directors sought to achieve with the MARAP and a revised market access program, which it had developed prior to commencement of the System initiative to develop a contractual agreement; and

(4) whether entering into the Agreement is reasonable in view of the alternatives available to the Funding Corporation.

Following the discussion of these matters, the Funding Corporation's Board of Directors unanimously determined it was in the interest of the Funding Corporation to approve the Agreement in principle. This Board of Directors decision was, and continues to be, strongly supported by the Board of Directors and the management of the Funding Corporation. (The Boards of Directors of the System Banks have similarly reviewed in detail the Agreement and have conceptually approved it.)

See comment 4.

Third, the Agreement contains a number of key provisions which provide important benefits which may not be achievable without significant delay and/or costly litigation under any unilaterally-imposed Funding Corporation market access program.

As the draft report acknowledges, there is not agreement within the System as to whether the reference to "conditions of participation" in Section 4.9(b)(2) of the Farm Credit Act empowers the Funding Corporation to restrict System Banks from participating in the issuance of Systemwide debt securities. The Agreement surmounts this problem through voluntary concurrence by all System Banks and the Funding Corporation in a contractual mechanism. The Funding Corporation views that mechanism as fully fulfilling that legal duty and responsibility

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under Section 4.9(b)(2) of the Farm Credit Act. Moreover, all the Banks, including those who view Section 4.9(b)(2) as not conferring any market restriction or prohibition powers on the Funding Corporation, agree that the contractual mechanism is authorized under Section 4.2(d) and consider the Agreement to be in their best interests from a business perspective. In addition, included in the Agreement is a covenant by all the parties not to litigate over the restriction or prohibition of a Bank from participating in the issuance of Systemwide debt securities pursuant to the Agreement's terms. Another benefit is the advance agreement by all System Banks to provide information needed to assess the financial condition of a financially-troubled Bank and the merits of its continued participation in the issuance of Systemwide debt securities. In its discussion of the MARAP, the draft report notes "[t]here is continuing controversy over whether the Funding Corporation can require banks to submit information they decline to provide voluntarily." By providing for access to appropriate information on a timely basis for the purposes of making market access decisions, the Agreement also resolves this issue in a satisfactory manner and avoids what could potentially have been a problem, as previously noted, for a unilaterally-imposed Funding Corporation market access program. Furthermore, the Agreement contains a provision which precludes any Bank that has failed to meet the Agreement's financial covenants from withdrawing its resolution authorizing joint and several liability on issuances of Systemwide debt securities.

Consideration of these provisions is important in any analysis of the relative merits of this Agreement and the MARAP or any other market access program implemented unilaterally by the Funding Corporation.

See comment 5.

Party Status for FCA and the Insurance Corporation

The draft report suggests it would be "improper" for FCA and the Insurance Corporation to become parties to the Agreement because they "have specific responsibilities and powers as the System's arms-length regulator and the insurer" of Systemwide debt securities, and joining in the Agreement as parties "could limit the options available to them in dealing with System banks." In fact, the Agreement is designed specifically not to limit the options now available to FCA and the Insurance Corporation in dealing with System Banks.

FCA retains all of its present powers of examination and enforcement, including the ultimate power to bar a financially-troubled Bank from participating in the issuance of Systemwide debt securities and to place such a Bank in receivership. The Agreement expressly acknowledges those powers, and specifically accommodates them by providing FCA can override any decision by the System Banks which would otherwise permit the continued participation by a financially-troubled Bank in the issuance of Systemwide debt securities. The Agreement does not allow FCA to override a decision by the System Banks to exclude a financially-troubled Bank from the market, but this should not impinge on FCA's powers because, under Section 4.2 of the Farm Credit Act, joint borrowing is specifically a matter committed to the voluntary decisions of System Banks.

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With respect to the Insurance Corporation, it too retains all of its present powers to secure information from financially-troubled System Banks, to provide financial assistance to such Banks, and to facilitate mergers by such Banks. Again, the Agreement expressly acknowledges these Insurance Corporation powers.

The System parties to the Agreement have not insisted FCA and the Insurance Corporation become parties to the Agreement as a precondition to its effectiveness; they have made clear they are prepared to implement the Agreement even if FCA and the Insurance Corporation elect not to become parties, so long as FCA approved the Agreement's terms in advance (an absolute prerequisite, under Sections 4.2 and 4.9 of the Farm Credit Act, for the Agreement's effectiveness). However, most System parties are of the opinion that there are certain advantages to the FCA and the Insurance Corporation being parties to the Agreement, while one System Bank is of the opinion there are certain disadvantages.

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The following are GAO's comments on the Farm Credit System's September 1, 1993, letter.

GAO Comments

1. On the basis of FCA's required revisions to the agreement and after considering all comments received, we withdrew our recommendation that FCA require the Funding Corporation to retain its ability to monitor and analyze the financial condition of System institutions and that its board be responsible for market access decisions subject to FCA's approval. While we continue to believe that there are programmatic benefits to having the Funding Corporation perform market access monitoring and decisionmaking functions in its own right, we do not take issue with the Funding Corporation's decision that these functions would be better performed by the System. We incorporated the System's comments regarding the proposed agreement in chapter 4, pages 123 to 127.

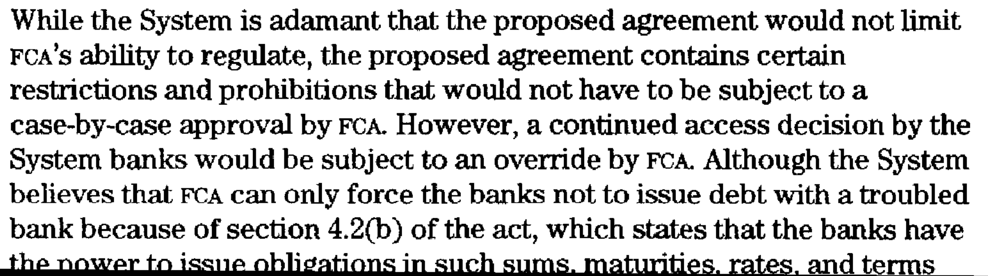
2. While the proposed agreement may be designed to fulfill the duties of the Funding Corporation as they relate to conditions of participation, it also supplants the Funding Corporation's current market access program. We maintain that the proposed agreement substantially changes the role of the Funding Corporation in market access decisionmaking. The issue is whether the change is important given the Funding Corporation's apparent comfort with the change. Concerning the involvement of the Funding Corporation in developing CIPA and the proposed agreement, both issues were addressed in the draft report and remain unchanged. We disagree with the System's implication that the Funding Corporation's input on the committee will be the same as its input under MARAP, considering the Funding Corporation will have two representatives to the committee, as will all of the banks.

3. Nothing in chapter 4 was intended to indicate GAO disapproval of the "agreement concept." Instead, our concerns involved several programmatic issues surrounding the proposal. Our draft stated that we have several concerns with the draft agreement as written. While the Funding Corporation Board unanimously approved the proposed agreement, it had also unanimously approved another plan to fulfill its duty (i.e., MAP, discussed in ch. 4) in August of 1992.

4. Given the litigious history of the System, some of the agreement's proposed benefits are questionable. However, we concur that the proposed agreement does provide information to the committee that may

be needed for market access decisions. In addition, FCA's preliminary approval is conditioned on information being made available to the Funding Corporation. As noted in our comment 1, we continue to believe there are benefits to having the Funding Corporation perform the market access functions but we do not take issue with the Funding Corporation's decision that the System could better perform these functions.

5. We continue to believe it is improper for FCA and FCSIC to become parties to the proposed agreement because it is a self-disciplinary arrangement among System entities.


While the System is adamant that the proposed agreement would not limit FCA's ability to regulate, the proposed agreement contains certain restrictions and prohibitions that would not have to be subject to a case-by-case approval by FCA. However, a continued access decision by the System banks would be subject to an override by FCA. Although the System believes that FCA can only force the banks not to issue debt with a troubled bank because of section 4.2(b) of the act, which states that the banks have the power to issue obligations in such sums, maturities, rates, and terms

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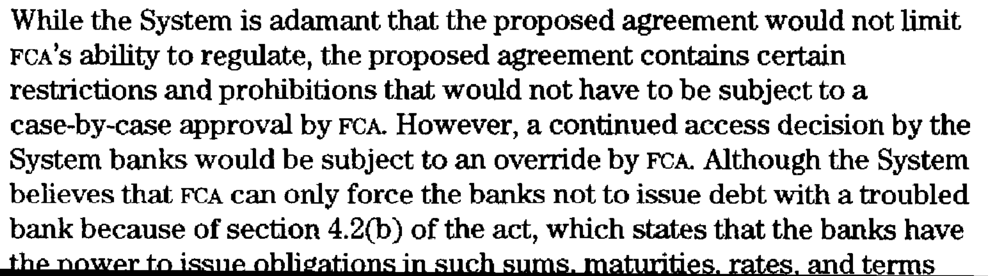

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