The Director's Role

Farm Credit System Institutions

Contents

Note to Readers

"The Director's Role" incorporates several new requirements from FCA's Governance Final Rule, which was published in the *Federal Register* on February 2, 2006. Most provisions of the new rule became effective April 5, 2006. However, the rule delays the implementation date of three requirements for one year from the effective date to April 5, 2007. The following is a list of the three sections in this publication for which the implementation date is postponed for one year.

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11	Outside Directors Minimum of two outside directors for banks and each association with total assets greater than $500 million	April 5, 2007
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Foreword

It is an honor to be elected or appointed to the board of directors of a Farm Credit System (FCS or System) bank or association (institution). It is an expression of stockholder or board confidence in the director's ability to oversee the institution's safe and sound operation for the benefit of member-borrowers.

That honor, however, carries numerous responsibilities. This booklet provides guidance and information about the duties, responsibilities, relationships, and liabilities of FCS institution directors. Although written primarily for bank and association directors, the booklet has relevance for directors of service organizations as well. The booklet does not cover all of the ramifications of the director's role but describes some of its major components. It is not intended to be a substitute for consultation with legal counsel. Directors are urged to seek advice from legal counsel or other qualified advisors when faced with specific circumstances.

The Farm Credit Administration (FCA or Agency) wishes to acknowledge the importance of the following publications in producing this booklet:

The Director's Book—The Role of a National Bank Director,
published by the Office of the Comptroller of the Currency

Director Liability in Agricultural Cooperatives,
published by the Agricultural Cooperative Service,
U.S. Department of Agriculture

Director's Responsibilities Guide,
published by the Office of Thrift Supervision

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Additional information about the FCA and the FCS is available on FCA's Web site at www.fca.gov.

Introduction

The financial institutions and service organizations that compose the FCS are federally chartered entities, organized to carry out the mandates of the Farm Credit Act of 1971, as amended (Act). The Act provides for a farmer-owned cooperative credit system that extends credit and related services to farmers, ranchers, farm-related businesses, farmer-owned cooperatives, and rural homeowners.

System institutions are regulated and examined by the FCA, an independent agency in the executive branch of the U.S. Government. The FCA was created in 1933 by an Executive Order of President Franklin D. Roosevelt but now derives its powers from the Act. Regulations issued by the FCA have the full force and effect of law. Because the authority and responsibilities of System institutions and their directors are derived from Federal law and regulations, directors of these institutions need to be familiar with both.

The FCA helps inform directors and management about legal and regulatory matters, as well as other Agency concerns, by disseminating a variety of materials to all System institutions and, as appropriate, to individual directors. It disseminates information in several ways: via hard copy, FCA news releases, e-mail, and the Federal Register. In addition, the FCA provides pertinent information, such as announcements of public hearings and more detailed explanations of regulations and other issues, on its Web site at www.fca.gov. The Web site also contains the following resources.

FCA Handbook. The *FCA Handbook,* which is updated as changes are made, contains statutes, regulations, FCA Bookletters, FCA Proposed Regulations, FCA Board Policy Statements, Title V Ethics Supplementals, and Farm Credit System Insurance Corporation (FCSIC) Regulations.

FCA Examination Manual and Updates. This manual contains concepts, guidelines, and procedures for the examination of FCS institutions.

Uniform Peer Performance Report (UPPR). Produced quarterly, the UPPR provides comparable financial and operating ratios for like-sized institutions. Every quarter-end, each FCS institution submits certain financial and operating information to the FCA. The UPPR, which is a product of this quarter-end analysis, can be particularly useful to institution directors. Institution directors can review this report to learn how their institutions compare with others.

Board Reports. These reports are produced after each FCA Board meeting to document actions taken since the previous meeting.

Board of Directors

Congress set up the Farm Credit System in 1916 as a cooperative because it wanted to ensure that the System could fulfill its public mission of providing long-term and affordable credit services to agricultural and rural America. A cooperative structure allows farmer-borrowers to own and control the System and keeps the System committed to serving rural credit needs. This is an important feature that sets the System apart from most other commercial lenders.

Cooperative Principles

The Farm Credit System is guided by seven cooperative principles shared by other co-ops around the world. Cooperatives trace the roots of these principles to the first modern cooperative founded in Rochdale, England, in 1844.

1. Voluntary and Open Membership

Cooperatives are voluntary organizations, open to all people able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.

2. Democratic Member Control

Cooperatives are democratic organizations controlled by their members—those who buy the goods or use the services of the cooperative. The members participate in setting policies and making decisions.

3. Members' Economic Participation

Members contribute equally to, and democratically control, the capital of the cooperative. "This benefits members according to the amount of business they conduct with the cooperative rather than the amount of money they invest in it."

4. Autonomy and Independence

Cooperatives are autonomous, self-help organizations controlled by their members. If a co-op enters into agreements with other organizations or raises capital from external sources, it does so based on terms that ensure democratic control by its members and the autonomy of the cooperative.

5. Education, Training, and Information

Cooperatives provide education and training for members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives. Members also inform the general public about the nature and benefits of cooperatives.

6. Cooperation Among Cooperatives

Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, regional, national, and international structures.

7. Concern for Community

While focusing on member needs, cooperatives work for the sustainable development of communities through policies and programs accepted by the members.

The board should understand the distinctive cooperative principles and philosophies its institution follows and should be aware of the implications of these principles and philosophies. The FCA conducted a study in 2005 to identify and better understand the range of cooperative practices employed by System institutions. The study found that, like most other cooperative organizations, the FCS institutions generally adhere to three core cooperative principles: user-ownership, user-control, and user-benefits. These principles are the underlying foundation for the System's cooperative practices and have been formally recognized by the U.S. Department of Agriculture.

Accountability and General Responsibilities

The Act provides that each System bank and association shall elect from among its voting members a board of directors of such number, for such terms, with such qualifications, and in such a manner as may be required by its bylaws. The regulations also require at least one member (two in certain larger institutions) to be elected by the other directors. The member(s) selected by the other directors shall not be a director, officer, employee, or stockholder of any System institution. These outside directors provide a valuable resource to the board. They allow the addition of directors with specialized skills and independent backgrounds.

The board of a System institution, like that of any corporate organization, is elected to oversee the management of the institution. Engaged and reliable directors play a key leadership role in financial institutions. FCS directors, like other corporate directors, owe fiduciary duties to the institution and must exercise reasonable care in governing the institution's activities. However, directors of financial institutions, including System institutions, face special challenges because federally insured financial institutions differ from private companies in an important aspect—they put the funds of others at risk through their lending activities. Depository institutions lend the funds of depositors. System institutions lend the funds of investors. As a government-sponsored enterprise (GSE), directors must protect the investing public, as well as the institution's stockholders. Additionally, directors, other than outside directors of System institutions, are faced with challenges unique to the cooperative structure, as both they and their fellow stockholders are also borrowers. Scrupulous objectivity is important when taking actions that may affect directors' interests as borrowers.

Directors are responsible for the safe and sound operation of the institution regardless of economic and financial conditions in local, domestic, and international markets. The directors are thus accountable to shareholders and investors for the following:

- Understanding the institution's operations.
- Providing for competent institution management.
- Establishing sufficient systems and processes that provide for safe and sound operations.
- Ensuring that information and disclosures to investors and shareholders are accurate and reliable.
- Diligently and impartially performing their duties as directors.
- Exercising independent judgment.
- Remaining loyal to the institution's interests.

The ultimate responsibility for the conduct of the institution's affairs lies with its management and the board of directors. The board establishes policies and strategies that govern how the institution carries out its business and ensures that those strategies and policies are implemented. Directors select and evaluate competent senior management, and they monitor and assess their performance. The board delegates day-to-day operations to management but remains responsible for ensuring that the institution operates within prescribed policies, in compliance with laws and regulations and in a safe and sound manner.

The board's effectiveness will depend, in part, on how well its members know the business it is directing. It will also depend on how well its directors work together to identify and address issues that are important to the success of the institution. Board members must diligently seek to understand the operations of the institution to faithfully execute their duties. They should also understand the industry and the community in which their institution does business.

Board composition is also important. Elected directors have an excellent opportunity to bring specialized financial institution management expertise, as well as other kinds of knowledge and skills, to the board through their selection of outside directors. Important new perspectives and objectivity can be provided by these individuals.

A well-organized board will examine the demands that will be placed upon it and identify areas that could be handled by committees. Matters that require detailed review or analysis might be better addressed in this manner. Serving on committees enables directors to develop more specialized knowledge of the institution's business. Typical committees are the executive committee, audit committee, compensation committee, risk management committee, and asset and liability management committee. It is the responsibility of the board to ensure that committee members have both the technical knowledge and experience for the committee to function effectively. When selecting committee members, the board should evaluate and assess the skills and experience of prospective committee members. Also, the board should ensure that committee members receive necessary training and access to third-party experts for committees requiring a higher degree of specialized skills or knowledge.

All committees should have clear written statements of their missions, authorities, responsibilities, and duration. Standing committees address continuing areas of responsibility, while ad hoc committees may be set up to handle special projects—for example, mergers or joint management agreements. It is also wise to rotate committee responsibilities to allow directors to broaden their knowledge and understanding of the institution's operations.

Committees should report regularly to the full board. If decisions are based on the recommendation of a committee, the board should ensure that the committee has done its work responsibly and that its recommendations are reasonable.

The board can delegate management authority to the institution's officers, but a delegation that is too broad, without appropriate standards, may be considered an abdication of the board's management functions. Delegation of such authority does not relieve the board of its legal responsibilities for the outcome.

Directors must understand the Act whose mandates the FCA is organized to implement. In addition, they must understand the role, operations, and regulations of the FCA because directors are ultimately responsible for ensuring that their institutions comply with statutes and regulations. The FCA regulates and examines System banks, associations, and related entities for compliance with applicable statutes, regulations, and safe and sound banking practices.

The Board and the Farm Credit Administration

FCA policy is vested in a three-member board appointed by the President of the United States with the advice and consent of the Senate. FCA Board members serve six-year staggered terms and may not be reappointed after serving a full term or more than three years of a previous member's term. The President designates one member as chairperson of the Board. The FCA Board is responsible for Agency policy, promulgation of regulations to implement the Act, and enforcement activities. FCA provides for the examination and supervision of the System, including the Federal Agricultural Mortgage Corporation; it approves corporate restructuring of System institutions; and it oversees the FCS Building Association, which is responsible for the management and maintenance of the FCA facility (owned by the FCS) in McLean, Virginia, and four leased office spaces in Denver, Colorado; Dallas, Texas; Bloomington, Minnesota; and Sacramento, California. FCA's three-member Board also makes up the Board of Directors for the FCSIC, which was created to insure FCS securities.

Examinations

The FCA Board and staff develop and interpret regulations and policies to accomplish FCS's mission. Congress requires that the FCA examine all FCS institutions at least once every 18 months, with the exception of Federal Land Bank Associations, which must be examined at least once every three years. Approximately one-half of the Agency staff is engaged in the examination function. Oversight and examination of institutions is conducted along functional lines by examiners in various locations throughout the United States.

In the past, every examiner followed prescribed procedures in conducting examinations. Today, examiners exercise flexibility in choosing examination procedures and the best method to communicate results and expectations for corrective actions, if any. Examiners make their decisions based on their assessments of the nature of the individual institutions, their degree of risk, and the adequacy of their governance and internal control systems. This risk-based examination approach has resulted in a more effective and efficient examination process. As much as possible, examiners complete examination work from their work locations, thereby avoiding travel costs and some of the disruption caused to institutions by the presence of examiners on site. Also, examiners are able to tailor the interval between examinations to the individual institution's risk profile. Smaller, well-managed, and sound institutions do not require the same amount of examination and oversight as do larger, more complex institutions or those that are troubled.

Because examinations may find flaws or weaknesses in institutions' operations and control processes or compliance with laws and regulations, management may at times be defensive about examiner findings. However, the institution directors should consider the examination as an objective and external assessment as to whether the institution is operating in a safe and sound manner and in compliance with laws and regulations. Reports that communicate the results of examinations are intended to be helpful to management by providing information about the conditions observed by the examiners and the corrective actions needed. Directors may not necessarily agree with all of the examiners' conclusions, but they should ensure that they understand and fully consider the basis for the conclusions reached by the examiners and how failure to address and resolve the underlying causes could affect the safety and soundness of the institutions.

Every 18 months (or more frequently, depending on an institution's condition) an examiner sends the board of each institution a written evaluation of the institution's condition, operations, and compliance with laws and regulations. In this report, the examiner includes an overall numerical rating of the institution. The Financial Institutions Rating System (FIRS) is similar to one used by other financial institution regulators; however, it has been modified to reflect the nondepository nature of FCS institutions. The examiner evaluates the institution's capital, asset quality, management, earnings, liquidity, and sensitivity to changes in interest rates (CAMELS). In addition to providing a rating from one to five (with one being the best) for each of these components, the examiner also provides a composite rating for the institution. These ratings are explained in the Examination Manual. FCA provides institution board members with the rating results to give them additional perspective on the condition of the institutions they lead, but the FCA urges directors to focus on the basis for the ratings assigned and not on the ratings themselves.

The examiners will make themselves available to meet with boards of directors, present their findings, and respond to questions from the board members. Most of the time, an institution's management is invited to take part in the meetings, but each meeting also should provide an opportunity for the board members to meet in executive session with the examiners without management present. Experience has shown that these private sessions are greatly appreciated by directors because they provide a free forum for discussions with examiners. In preparing for a meeting with the examiners, directors are advised to read examination reports thoroughly, along with any accompanying correspondence, and to come to the meetings prepared to ask questions.

Examination reports are not intended to diminish the directors' role in overseeing an institution's operations. Rather, they are intended to be useful tools to assist the board as it monitors the institution's safety and soundness and its compliance with laws and regulations. The institution's board has a duty to address report findings and take appropriate corrective actions in a timely manner and to ensure that underlying causes of problems found during examinations are addressed and resolved. During subsequent examinations, the FCA will evaluate the extent and effectiveness of the directors' efforts to resolve any problems noted in previous examinations.

The Board and the Farm Credit System Insurance Corporation (FCSIC)

Directors should also be familiar with the FCSIC and its importance to investors. The FCSIC is a Government-controlled corporation established by the Agricultural Credit Act of 1987. Congress created the FCSIC to renew investor faith in the financial integrity of the System. The FCSIC insures the timely payment of principal and interest on FCS notes, bonds, and other obligations issued to investors. The FCSIC is administered by a board of directors who serve concurrently on the FCA Board. The chairperson of the FCSIC Board is elected by the other members and may not serve concurrently as the FCA chairperson.

The FCSIC administers the Farm Credit System Insurance Fund (the Fund) and collects annual insurance premiums from FCS banks. Premium rates are calculated using a statutorily defined formula based on FCS loan volume, with different rates for accrual loans, nonaccrual loans, and loans guaranteed by Federal or state governments.

Congress directed the FCSIC to build the Fund to a "secure base amount." The secure base amount is defined as 2 percent of the aggregate of outstanding insured obligations of all insured banks, adjusted downward by a certain percentage of the FCS's government-guaranteed loans. The Farm Credit System Reform Act of 1996 gave the FCSIC Board the authority, in its sole discretion, to reduce insurance premiums from the statutory rates before the Fund reaches the secure base amount. Current information about the Fund's secure base and insurance premium rates can be found on the FCSIC Web site at www.fcsic.gov.

In addition to building and maintaining the Fund, the FCSIC has other mandatory and discretionary responsibilities. The FCSIC, in its discretion, is empowered to provide assistance to FCS banks and direct lender associations suffering financial difficulties by providing loans or contributions, purchasing assets and debt securities, assuming liabilities, and facilitating consolidations and mergers. The statute imposes a cost-test limitation for financial assistance whereby the total cost of assistance may not exceed the alternative cost of liquidating the institution. The FCSIC shall also serve as conservator or receiver of any FCS bank or association placed into conservatorship or receivership by the FCA Board and may serve as conservator or receiver, when appropriate, for other organizations regulated by the FCA. Another responsibility of the FCSIC is to insure the retirement of eligible borrower stock at par value. At yearend 2005, eligible borrower stock outstanding at FCS institutions totaled $16 million.

Board Structure and Composition

General. Each System institution has a board of directors, which is the governing body of that institution. The board of directors is responsible for establishing policies, providing strategic direction, hiring the CEO and providing for a plan of succession, overseeing management, and overseeing all major institution functions. In short, it has a fiduciary responsibility to represent the institution's stockholders. Because the System has a federal charter and is subject to regulatory oversight, it is incumbent on the board to ensure that the institution operates in a safe and sound manner and in compliance with appropriate laws and regulations. To accomplish this, the board must structure itself so that it has the requisite knowledge and skills to carry out its duties in a manner that is efficient and cost-effective.

Size. The board size should be large enough to provide adequate stockholder representation and to ensure that it has the collective skill set needed to address the challenges the institution faces, both current and projected. It must also be small enough to get meaningful input from each director and avoid developing the "rubber stamp" mentality frequently associated with larger boards. While the board and management form a partnership in directing the operations of the institution, the board still has an oversight responsibility. It, as well as its committees, should plan regular executive sessions, without institution officers or staff present, in connection with regularly scheduled meetings. This will facilitate open and candid discussion.

Outside Directors. Outside directors are valuable because they provide an independent and objective perspective to the board's deliberations. They also provide the board with valuable technical expertise. Regulations governing System banks and associations generally require that they have at least two outside directors. Associations with $500 million or less in total assets are only required to have one outside director. If a larger association's board size is so small that the addition of a second outside director would result in less than 75 percent stockholder-elected representation on the board, it is exempted from the requirement to have a second outside director. While the board is not prohibited from adding more outside directors, under no circumstances should stockholder-elected board representation drop to less than 60 percent.

Skills and Training. Both agricultural production and the financial services sector within which the System operates have seen considerable change over the last several years, and more changes are anticipated. Generally, these changes introduce additional elements of risk to institution operations and to institution borrowers. System institution boards have an obligation to continually reevaluate their collective skill set in light of these changes. Individual directors need to undertake training on an ongoing basis to stay abreast of these changes. System institution boards are required to develop policies for, and implement director training programs appropriate to, their institutions' needs. New directors must receive training in, and orientation on, all aspects of the institution's operations within 1 year of their election to the board.

Financial Expertise. Each Farm Credit institution board must have at least one director who is a financial expert. Boards of directors for associations with $500 million or less in total assets may satisfy this requirement by retaining an advisor who is a financial expert. The financial advisor must report to the board of directors and be free of any affiliation with the external auditor or institution management. A financial expert is one recognized as having education or experience in accounting, internal accounting controls, or in preparing or reviewing financial statements for financial institutions or large corporations consistent with the breadth and complexity of accounting and financial reporting issues that can reasonably be expected to be raised by the institution's financial statements. A financial expert on the System audit committee (SAC) must meet a higher standard. The SAC financial expert is one who either has experience with internal controls and procedures for financial accounting or experience in preparing or auditing financial statements.

Committees

Board committees should be viewed as extensions of the board to assist it in carrying out its fiduciary responsibilities. Others, such as the executive, governance, credit, and risk management committees, may be established by the board based on an assessment of the institution's needs and the board's best judgment. Once the determination to establish a board committee has been made, the board needs to draft a charter defining the committee's responsibilities and giving it the requisite authorities to carry out its responsibilities. The board must ensure that committees receive adequate support and resources necessary to carry out assigned duties. The board also needs to select fellow board members to sit on the committees. Careful consideration should be given to director qualifications in making these selections, and director training can play an important role in ensuring that committee members have and maintain needed knowledge and skills. Although the board may create a committee and charge it with specific responsibilities, this does not minimize or abrogate the fiduciary responsibility the board has to its stockholders. The board should require regular committee reports to ensure that all directors are kept appropriately and timely informed and able to exercise due diligence.

Audit Committee. Each institution must have an audit committee. An audit committee is the guardian of an institution's financial integrity. It recommends actions needed to provide full and accurate disclosure of the institution's operations in the most transparent manner possible. It oversees and reviews the preparation of the institution's financial reports and retention of the external auditor. It is important for audit committee members to be well-qualified board members because the committee acts on behalf of the board in carrying out its fiduciary responsibilities to stockholders. By effectively carrying out its responsibilities, a strong audit committee independent from management helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices, and that the external auditors objectively assess the institution's financial reporting practices. The audit committee reports only to the institution's board. It is responsible for preparing financial reports to shareholders and the public, appointing and overseeing the work of the external auditor, and overseeing each institution's system of internal controls.

Each System institution is required under FCA regulations to have an audit committee composed of at least three directors with some level of knowledge of public and corporate finance, financial reporting and disclosure, or accounting procedures. Within these parameters, each board has considerable discretion in defining the qualifications it wants each audit committee member to have. For those institution directors who, upon election or appointment to the board, might not have sufficient financial knowledge to serve on an audit committee, the institution should provide a training program in appropriate financial areas. FCA rules also require audit committees to hire the institution's external auditor, thereby minimizing potential or perceived undue management influence in the review of financial reports and accounting procedures. The audit committee's oversight is intended to provide auditors with a knowledgeable authority other than management with which to discuss controversial matters. Each audit committee must have at least one member who is a financial expert. Institutions with less than $500 million in total assets who retained an independent financial expert must require the independent financial expert to advise the audit committee in lieu of a board member.

The audit committee at the System-wide level need not be composed solely of board members, but, according to FCA regulations, at least one-third of the committee's members should be from the System. Because the SAC assists in setting the reporting and disclosure standards for the entire System, it should have broader representation from System institutions and deeper and broader financial knowledge and experience than other System institution audit committees.

Compensation Committee. A compensation committee is mandatory for each System institution. It must have at least three members who are members of the institution's board of directors. Each member of the compensation committee must be able to exercise independent judgment and be free of any relationship that would interfere with that independent judgment.

A well-defined compensation program, administered by a qualified, objective board committee, ensures that institutions have the needed structure for this important function, regardless of their size. The compensation committee must take an active role in monitoring compensation, and FCA regulations require the compensation committee to approve the overall compensation program for senior officers. A board committee performing the duties of the compensation committee, with a charter that satisfies committee requirements, may fill the role of a compensation committee, even though it has a different name.

Other Committees. Institution boards may determine that other board committees are needed to carry out the board's oversight duties in an efficient manner. These committees are not mandatory. Other committees common to good corporate governance, and particularly firms in the financial services sector, are risk management, governance, credit, and executive committees. It is important to note that, by law, a System institution's nominating committee is not a committee of the board; the System differs in this regard from many public companies and other corporate entities. For a complete discussion of the nominating committee and its role, see Appendix G.

The Board's Role in Strategic Direction and Business Planning

Unprecedented changes in the System and the financial services industry have heightened the importance of effective planning. Planning can be used as a tool to chart progress and maintain sound operations during periods of uncertainty and change. It is vital to the long-term success of the institution because it translates the board's vision into measurable goals with strategies to achieve them. By analyzing where the institution is and what the board wants it to be, directors are able to identify strategies to accomplish what they envision. As part of the planning process, directors should consider financial and human resources, as well as technological and organizational capabilities, necessary to achieve the board's long-term vision and goals. Because effective planning is essential to institutional health, the board must be fully involved in the planning process.

The planning process should be dynamic and ongoing. In its simplest terms, planning is the process of determining (1) where the institution is; (2) where it would like to be; and (3) how it plans to get there. Planning can be divided into two components, strategic and operational. Strategic planning is an ongoing process that focuses on the long-term deployment of resources to achieve institutional goals. Operational planning concentrates on short-term actions, which should flow logically with the development of a long-term plan that states the board's overall philosophy and its vision of the institution's future. Planning should detail strategies for attaining the short-term, sometimes routine, goals of business operations, as well as long-term goals. Short-term business plans should translate into long-term goals with specific, measurable targets. Also, plans should address modifications in resources and goals resulting from significant changes in the regulatory and economic environment.

The plan should identify those areas selected for strategic development, allocate resources, and provide the basis on which business decisions can be made and performance measured. Several strategies may be involved in achieving a particular goal. If, for example, the goal is to attain a certain net worth position, the business plan should incorporate strategies to retain capital, increase earnings, and grow assets. The board should ensure that its strategies and the use of institution resources will reasonably accomplish the intended purposes.

To properly direct an institution, the board of directors should first determine the operating environment of the institution. This is typically done by identifying the institution's internal strengths and weaknesses and by identifying external opportunities and threats. A thorough understanding of the operating environment allows the board to design goals and strategies to best meet the mission of the institution.

The board should also identify, analyze, and address risk as part of the planning process. By understanding and defining existing risks, the board learns their causes and how they could affect future performance. By defining risk, projections can be made and financial needs determined. Once risks are defined, the board can require management to explore alternative methods for managing the institution's exposure to these risks.

The board should establish reporting requirements for each component of the plan and review the institution's performance at least quarterly to evaluate the appropriateness of both the strategic and operational components. During the review, directors should consider new opportunities, changes in the operating environment, and external developments to decide whether adjustments to the strategic direction are needed. The board should establish contingency plans in case actual results vary from planned goals and objectives.

The Board's Policy-Making Role

The board is ultimately responsible for the success of the institution; thus, it is essential that policies approved by the board provide sound direction to management. In addition to policies required by statute or regulation, the board should develop policies addressing all significant aspects of the institution's operations. Such policies would include those specific to each area of operations that relates to the institution's pursuit of its mission and the discharge of its chartered authorities. Also, policies may be needed to address specific institutional programs or activities. The institution's charter or bylaws may also dictate areas requiring policy direction. Other sources to be considered when establishing needed policy direction are industry standards, emerging issues, and authoritative sources providing guidance on governance issues and best business practices.

Effective policy development can be accomplished using various approaches. For example, the entire board could establish broad guidelines and set a general direction for a given policy. Responsibility for more detailed aspects of a policy might then be delegated to a board committee or to management. Using this approach, the full board would adopt a general policy statement on standards of quality that must be met before credit is extended. The appropriate committee of the board would outline the specific elements to be addressed in the policy. Management would then prepare the details necessary to address those elements and the manner in which they are to be implemented. In another case, after providing general guidance and direction, the board might delegate the entire drafting of the policy and procedures to management. No matter how policies are developed, they are ultimately approved by the board, and the board remains responsible for them. Before approving policies, the board must ensure that they are appropriate for the institution and supportive of strategic objectives.

The board should ensure that policies are thoroughly understood at all levels of the institution. This is best done through written documents that can be maintained in a policy manual providing a single and authoritative reference. A better understanding of more complicated policies and procedures can be gained through training programs.

Regardless of the process used in policy development, an effective policy should include or address the following components:

Purpose. A statement of purpose should clearly articulate the intention behind the policy or the policy's goals. The purpose of some policies is straightforward and relates to specific areas, such as loan programs, human resources management, or capitalization and dividends.

Objectives. Policy objectives may be simple statements that require the institution to comply with a specific law, regulation, or business practice. Objectives may be linked to specific business plan goals related to capitalization, earnings, asset growth, or interest rates; or the objectives may address expectations related to the management of investments or other assets, interest rate risk, liquidity, asset quality, or liabilities.

Delegations. Each policy that requires specific action by committees, officers, or employees of the organization should clearly define which authorities are delegated by the full board and which are retained by the board or by a board committee. For example, the full board might adopt a policy that establishes limits on concentrations of risk in various portfolio segments or limits on loan size in relation to the institution's capital base or risk funds. In such instances, the chief executive officer (CEO) may be authorized to approve loans up to a certain amount within the established limits, whereas loans in excess of the limits might require approval or review by the board. The board must ensure that delegated and retained authorities are appropriate and that the board is neither abdicating its authority nor unnecessarily restricting the institution's operations.

Exceptions to Board Policy. Unexpected and urgent matters may arise that require immediate attention and greater authority than has been delegated to management. The board's policy should clearly define a process to handle such contingencies.

Reporting Requirements. Each policy should have well-defined reporting requirements for management. The policy should specify what is to be reported; how frequently reports should be issued (monthly, quarterly, semiannually, etc.); and who is responsible for generating the report. These reports to the board should enable directors to evaluate the policy's effectiveness and impact. They should include actions taken under delegated authorities and actions taken as exceptions to policy. The overall body of reporting requirements set by board policy should provide sufficient information to keep the board fully apprised of the institution's business affairs.

The board should periodically evaluate whether policies are accomplishing their intended objectives and goals. Typically, the internal auditor evaluates the institution's compliance with board policies, and management evaluates the policies' effectiveness. In some instances, the internal auditor may evaluate both compliance and effectiveness.

The board might schedule the review of certain policies at board meetings or provide a committee to review policies on a regular basis. However, there may be times when an immediate review of a policy is required because of changes in law, regulations, the business environment, or the institution's business performance or risk profile.

The board must ensure that policies adequately direct and control the business affairs of the institution at all times. Hence, policies should be reevaluated and revised as necessary to ensure the successful operations of the institution.

The Board's Oversight Role

In today's world of corporate governance, System boards of directors must recognize and accept the need to maintain a strong oversight role over their institutions' performance. Institution operations, as communicated to stockholders, investors, and the public in reports and disclosures, must reflect a transparency and truthfulness that will ensure that safety and soundness are maintained. The board's oversight role must be sufficient to meet that standard. Each member of the board shares this fiduciary obligation.

In addition to the traditional responsibility to furnish sound, adequate, and constructive credit and related services to eligible applicants and borrowers, System institutions bear the responsibility to meet the growing financial needs of agriculture and rural America in the 21st century. In this light, FCA believes that sound business, ethical, and mission-related performance must be key board objectives. Measuring performance in each respective area is a good way to measure the board's success in directing and overseeing the institution.

Business and Financial Performance. For any financial institution to remain in business, it must be profitable and maintain adequate capital over the long term. Thus, business and financial performance is more than how much was earned—it is also the quality of the earnings and the institution's ability to sustain those earnings. To assess the quality of earnings, directors must understand the institution's entire operations and the relationships among interest earning-assets, interest-bearing liabilities, capital, and off-balance-sheet items such as derivatives. Further, quality earnings result from fundamental institutional strengths: ability to identify and manage risks, quality assets that can weather adversity, well-controlled expenses, effective asset/liability management, proper loan pricing, knowledge of the institution's operating environment, and the effect of competition.

The directors must understand the institution's entire financial and credit operations, as well as the relationships among operating statistics, to evaluate the quality of earnings. To facilitate this effort, each new director should be given training and orientation into all aspects of the institution's business. The board should evaluate the institution's business carefully, looking behind the numbers to verify that earnings are not artificially inflated with delays in chargeoffs or insufficient provisions for loan losses. Regular reports by the institution's audit committee, as well as FCA examination reports and reports by independent public accountants and internal reviewers, may assist directors in ensuring reliability of reports to the board, shareholders, investors, and the public. CEO and chief financial officer (CFO) attestations on financial reports should also help to ensure accuracy in financial reporting.

Not all directors are financially literate and capable of evaluating the institution's financial performance. FCA regulations do require that at least one director be a financial expert or, for smaller institutions, that the board retain an independent financial expert. Directors also have authority to enlist the help of an independent financial expert to assist them in this responsibility. Moreover, FCA governance regulations require each institution to have a chartered audit committee, and for institutions with greater than $500 million in assets, at least one member of the committee must be a financial expert. All board members should be able to discern poor operating performance, and they may also seek training under the institution's director training program to enhance or reinforce their financial skills and aptitude. Directors should realize that there are no model numbers or ratios that guarantee success but that certain accepted business ratios are guides to the success or failure of the institution. Board members need solid financial data and should ensure that analyses are completed that support the institution's financial and operating results. Board members can achieve this by asking the following questions:

- Is management meeting the targets established in the business plan? If not, why?

- Is the level of earnings consistent or erratic?

- Do earnings result from successful implementation of strategies or from questionable accounting practices?

- Are earnings an accurate portrayal of the institution's financial picture, or are they distorted by an incomplete evaluation of asset quality or potential losses?

- Is too much emphasis placed on short-term financial performance indicators rather than long-term indicators?

- Are significant findings from internal and external audits and reviews routinely delivered to the board and/or the audit committee?

- Does the board's audit committee charter vest the committee with adequate authority and clearly describe its responsibilities? Is there adequate financial expertise on the committee?

Directors are not expected to have all the answers, but they must ask the right questions and ensure that responsible answers are provided. Directors should periodically ask individual key management employees questions regarding the institution's condition and performance, not just when problems arise. Accordingly, directors should attend every board meeting and arrive prepared, having reviewed all available information in advance. Directors should ask questions to become familiar with the documents and transactions they are asked to approve and the risks associated with the transactions. Finally, boards should make informed decisions—if something is confusing, they must get a satisfactory explanation from management or an outside expert and insist that all decisions are well documented.

The board, and especially its audit committee, should be provided with sufficient financial information so that the institution's performance can be evaluated. The board should be satisfied that it has adequate financial expertise on its audit committee to assist the board in the conduct of its fiduciary responsibilities to stockholders. The audit committee should be expected to provide regular reports to the full board. Some of this financial information is represented by key financial ratios and data relating to critical aspects of operational performance. The board should understand the significance of and trends in these ratios. Appendix B of this booklet discusses several key financial ratios to help directors familiarize themselves with, and track, the institution's financial performance.

Operational Performance and Asset Quality. The principal assets of FCS institutions are their loans to America's farmers, ranchers, rural communities, individual residents of rural communities, and farm-related businesses. Therefore, the quality and performance of those assets are of paramount importance to the institution. FCA believes that there are some key indicators that measure changes in asset quality. The number of performing, criticized, adversely classified, restructured, high-risk, past-due, and nonaccruing loans reflects the quality of assets and directly affect the institution's overall operational performance and condition. Management should fully explain any variation in the quality or volume of loans. The board, and especially its audit committee, should closely monitor the findings of the internal credit review and any weaknesses discovered in lending processes and practices. Sufficient controls need to be in place so that assets are managed in accordance with sound business practices.

Asset quality statistics should clearly and concisely show both the institution's current position and its historical trends. The volume and percentage of each loan risk category should be discussed so that the board understands the reasons for any changes and thus can evaluate its underwriting standards and lending policies. Unusually poor asset quality may reflect weaknesses in lending policies or inadequate underwriting standards, both of which require prompt corrective action. Similarly, problems with nonearning assets, which include nonaccrual loans and acquired properties, also require prompt corrective action. The board should recognize that although deviations from acceptable asset quality may occur periodically, the board is ultimately accountable for ensuring that lending programs preserve and enhance the institution's capital, regardless of the operating environment.

Any institution can encounter problem credits. Sometimes they result from a breakdown within the institution, which requires quick board correction of the "process" problem that led to the troubles. Sometimes they result from unforeseen circumstances beyond the institution's control. In any event, it is important that problem credits receive close attention. A plan of correction or collection should be put in place on each troubled credit. In many instances, the board may wish to approve the individual correction plan and be provided with periodic progress reports. But in all instances, the board members should ensure that plans are being put into place and are being followed. A neglected problem credit is more likely to result in loss than one that is well administered.

Mission-Related Performance. One of the board's most important responsibilities is ensuring that the institution accomplishes its mission, goals, and objectives. The mission of the Farm Credit System is clearly delineated in its enabling legislation: to improve the "income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations." To meet these critical goals, the board must ensure that the institution has sufficient capital. Establishing capital goals should not be limited to FCA regulatory requirements because these requirements only prescribe the minimum required of each institution. An institution's capital needs depend on its operating environment, risks that exist within the institution, and the goals set by the board. The board must carefully monitor all components of capital, both stable and transitory, to keep the institution's financial foundation sound. Most institutions will likely require more capital than the regulatory minimum. A determination of the amount of capital appropriate for an institution should result from analysis by the board and management. Most importantly, capital levels should be reflective of the risks within the institution—existing and anticipated.

The Farm Credit Act further states: "It is the objective of this Act to continue to encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture which will be responsive to the credit needs of all types of agricultural producers having a basis for credit, and to modernize and improve the authorizations and means for furnishing such credit and credit for housing in rural areas made available through the institutions constituting the Farm Credit System." Explicit in this objective is that the System is a cooperative and should function under cooperative principles. Core cooperative principles include user-benefits, user-ownership, and user-control.

The board should actively seek and encourage stockholder participation in setting the direction for the institution. The board should understand the distinctive cooperative principles and philosophies the institution holds and be aware of their implications, especially as they relate to stock and patronage. The board has the discretion to determine capitalization, either through direct borrower investments or earnings retention. With respect to patronage, the board needs to determine if the institution's current-year earnings are sufficient to return patronage. The board should carefully evaluate the institution's earnings performance, capital adequacy, and future business strategies before it determines the amount of patronage distribution.

The board must also be mindful that the System was intended for all types of producers, not just existing stockholder-borrowers. Programs for young, beginning, and small farmers are required. Implicit in the above objective is the need for diversity; benefits, ownership, and control should be available for all types of producers, including women and minorities within the institution's territory. It is the board's responsibility to develop plans and policies that will extend the full range of allowable System benefits to all types of eligible borrowers within its territory.

Board Evaluation and Ethical Principles. Directors are responsible for a thorough evaluation of the board's effectiveness in achieving safe and sound operations and in operating within applicable laws and regulations. Accordingly, the board needs a systematic approach for evaluating its own performance and that of each of its committees. The board evaluation should assess the full range of the board's governance capabilities, particularly in light of existing and projected circumstances. FCA regulations require board evaluations—as well as strategy development for correcting identified weaknesses, if any—on an annual basis. This is most appropriately done in connection with annual planning and review of the institution and its management. Finally, sound ethics, adherence to standards of conduct, and sufficient director training and expertise will assist directors in fulfilling the oversight role of today's boards. It is to the board's benefit to ensure that an appropriate code of ethics is developed, reviewed on a periodic basis, distributed to all appropriate parties and prominently displayed, and adhered to by all parties.

The Board's Relationship with Management

Boards of directors have the ultimate responsibility for the affairs of the institutions, and sound corporate governance dictates that a proper and independent relationship between the board and management be established and maintained. The board can fulfill its responsibility and help protect the institution's future by making sure that day-to-day operations are properly managed. Every soundly run and successful operation is led by a quality management team. Therefore, the board's duty in hiring and retaining quality management becomes one of those critical elements, if not *the* most critical element, necessary for the institution's success. Consistent with these sound governance principles and FCA's governance regulations, especially § 620.31, each institution must charter and maintain a formal compensation committee.

The board is responsible for hiring the CEO of the institution. A CEO must have the expertise necessary to assist and support the board in carrying out its fiduciary responsibilities. The board should consider integrity, education, technical competence, and sound lending and management experience as key considerations in any CEO selection process. Management should also understand the cooperative philosophy and principles upon which the institution is based. At all times, directors must pay attention to their fiduciary responsibilities and be diligent in their efforts to ensure that management is carrying out the institution's mission and goals.

Notwithstanding its cooperative philosophy, the board should ensure that the institution is operating as a profit-oriented business and maintains financial stability to serve future generations of borrowers. Short-term problems must not be allowed to affect long-term objectives. Board committees, such as the audit committee, and management should identify problems and provide solutions that ensure financial stability. Further, the quality and strength of the institution's management may be the difference between success and failure during difficult economic times or swings in the rural economy.

The board may want to use its compensation committee to institute a formal process to evaluate management performance and ensure that periodic evaluations are a part of the ordinary course of business. These actions demonstrate that the board is discharging its responsibility for supervising management. Clear standards of performance and measurable key results should be defined to ensure that management fully understands the board's performance expectations and that it is accountable for fulfilling those expectations. The board cannot be "asleep at the switch" and leave management alone to set its own performance standards and then measure its own performance.

The business success of the institution, its record of complying with applicable laws and regulations, and management's responsiveness to board directives are among the key factors that should be evaluated. The timeliness, quality, and accuracy of management's recommendations and reports to the board and adherence to the institution's business plan should also be considered. The degree to which the institution's objectives have been achieved, actual versus projected performance, and comparisons with similar institutions are other performance measurements that can be used to evaluate management. Finally, FCA Reports of Examination, external audit reports, and internal business performance and credit quality indicators provide additional information to help in the board's evaluation process.

If performance expectations are not being met, it is the responsibility of the board to deal with the situation immediately. Although timely and effective communication may prevent serious problems from developing, occasionally the board will find it necessary to dismiss management for poor performance, dishonesty, conflicts of interest, or other reasons. All such actions should be properly documented in the institution's official records. When such circumstances dictate, a board's failure to act expeditiously may represent a serious breach of its fiduciary responsibilities.

Another board responsibility in its relationship with management is identifying and developing a successor CEO. Sound governance dictates that the board should have a succession policy for its CEO. If no individual in the institution is suitable to succeed the CEO, a competent and experienced temporary replacement should be identified. Contingency plans should be reviewed annually because one measure of a good CEO is the strength and expertise of the entire senior management team. Succession planning for the other critical management levels, including, but not limited to, the chief financial officer, the chief credit officer, and the chief information officer, is a good measure of a well-run institution and an effective CEO.

With the enactment of the Sarbanes-Oxley Act in 2002 and the implementation of amended FCA governance regulations in 2006, the board's relationship with management has fundamentally changed. Whereas the board at one time simply followed management's lead, today the board leads proactively in collaboration with management. We expect boards to be more involved in overseeing management and in setting their institutions' strategic direction and mission to represent all their stockholders and America's rural communities.

Legal Responsibilities of Directors

System institutions are governed by the Act and are subject to other Federal laws and regulations. A director who fails to comply with statutory or regulatory mandates, engages in unsafe or unsound practices, or breaches a fiduciary duty (or permits another person to do so) may be held personally liable and subject to monetary penalties or other sanctions. The director may be held responsible either alone or jointly with other board members in lawsuits brought by shareholders/investors and in FCA enforcement actions.

Common Law Liability

In addition to the standards established by Federal law and regulations, there is also a body of common law against which the performance of directors is measured. Common law is the body of law that is made up of cases decided by the courts and that constitutes generally accepted legal principles. Common law and statutory provisions, including Federal statutes and state corporate and fiduciary statutes, often address the same conduct. Hence, a lawsuit against a director could allege a violation of common law or statutory law.

In the exercise of their institutions' corporate powers, directors owe common law duties to their institutions and their stockholders similar to the fiduciary duties of trustees. By accepting the position, the director assumes a fiduciary duty to the institution and its stockholders (and in some instances, to its creditors) and is therefore liable for damages resulting from a breach of that duty. A fiduciary status signifies a special relationship between a director and the institution, which is characterized by trust and confidence in the director and his or her integrity. It also imposes certain obligations the director owes to the institution. The fiduciary duties of a director are typically described as the duties of due care, obedience, and loyalty.

Due Care. The duty of due care holds directors to a standard of care in performing their jobs equal to that which a reasonable and prudent person would exercise in similar circumstances. This means that directors must make a reasonable effort to gather and consider relevant information. What "reasonable" is varies by courts, but when a court examines whether a director has fulfilled the duty of due care, it measures the director's conduct against that of a hypothetical director of ordinary diligence, possessed of the same information and acting under similar circumstances, not against the conduct of an expert. Courts often will consider special factors that might affect how the hypothetical director would act. The courts have found a lack of due care when directors have made a habit of missing meetings or not reviewing such essential documents as the quarterly and annual reports. Another responsibility considered part of due care is the hiring and supervision of management. Though not responsible for the day-to-day operations of their institutions, directors are expected to hire competent managers and establish policies and procedures to guide management. They are also expected to evaluate how well management is fulfilling its duties.

The duty of due care carries with it the obligation to investigate and to exercise the care of a prudent person in making decisions on behalf of the institution. When circumstances alert directors to an actual or potential problem, the duty to investigate requires that they learn the facts and resolve the situation. Not only must directors act in a careful manner, but they must also not neglect to act. For instance, a director who learns about an auditor's or examiner's criticism, whether by informal communication or written report, must make sure that the board and management review the matter and take any needed corrective action. Similarly, a director may be responsible for monitoring resolution of a problem to prevent recurrences. Directors have been held liable for failing to attend board meetings, failing to maintain adequate audit procedures, permitting false statements to be made in reports, failing to supervise excessive loans to delinquent borrowers, and failing to examine reports (including Reports of Examination) that pointed out problems warranting attention.

Obedience. The duty of obedience requires the director to act within the limits of power granted by the institution's charter, articles of incorporation, bylaws, statutes, and regulations. To discharge this duty faithfully, directors must familiarize themselves with the legal constraints under which their institutions operate and seek legal counsel when they are uncertain about whether a particular action is authorized. Directors must also keep themselves sufficiently informed about their institutions' activities to provide adequate supervision of management.

Loyalty. The duty of loyalty generally prohibits directors from placing their personal or business interests or those of others above the interests of their institutions. Directors must deal fairly with their institutions, refrain from letting personal interests affect their decisions, and always act honestly and in good faith. The duty of loyalty does not mean that directors absolutely may not do business with their institutions or participate in transactions in which these institutions may have an interest. It does mean that directors must disclose fully to the board any personal interest they may have in matters affecting their institutions and ensure that any transactions involving these interests are evaluated and that decisions are made by disinterested directors. The duty of loyalty requires directors to adhere to standards of fairness, avoid the usurpation of corporate opportunity, avoid misusing their positions, and disclose conflicts of interest.

Additional Considerations

Adhering to Standards of Fairness. Directors must observe strict standards of fairness in handling their own transactions and those of other member-borrowers. Directors must never favor some member-borrowers over others who are similarly situated.

Avoiding the Usurpation of Corporate Opportunity. Directors must not take personal advantage of business opportunities that might benefit their institutions without first offering those opportunities to their institutions.

Avoiding the Misuse of Position. Directors must not use influence or knowledge acquired through their official position for personal gain or the gain of others. Directors must deal with their institutions' assets solely for the benefit of their institutions and their member-borrowers. Institution assets must not be appropriated, given away, or wasted.

Disclosing Conflicts of Interest. When a director stands to gain personally from a proposed action or inaction by his or her institution, a conflict of interest may exist; the legal and regulatory problems that directors encounter often result from such conflicts. When directors question a possible conflict of interest, they should ask the institutions' standards of conduct officer whether an actual or apparent conflict exists and whether they can participate in considering the matter at issue. Appendix F contains further information dealing with conflicts of interest. In all jurisdictions, directors are required to disclose conflicts of interest with their institutions and to refrain from considering or voting on any matter in which a conflict exists and from attempting to influence the vote of others on such matters. A prudent director will avoid even the appearance of a conflict of interest by disclosing the apparent conflict to the institution and by refraining from considering or voting on the matter.

Directors are not expected to be insurers or guarantors of their institutions' success or of the conduct of the officers. Nor are they expected to be all-knowing in their business decisions regarding the institutions. Directors are expected, however, to carry out their duties in good faith, in the best interest of their institutions, with diligence, and with the exercise of unbiased, independent judgment.

The Business Judgment Rule

A director who has done so may be protected from liability by the business judgment rule. This doctrine recognizes that without allowance for honest error, no director could afford to be associated with the position. It means that courts will not second-guess the director's decision even though it may turn out to be wrong and bring hardship to the institution. However, in order to invoke the business judgment rule, the director must first have fully met the duties of care and diligence implicit therein. The director's decision-making process involves careful consideration of the reasonably available and relevant facts necessary to making a well-informed decision, and the director must honestly and reasonably believe that the decision was in the best interest of the institution.

It is also important to document the board's decision-making process because the courts are less likely to examine the substance of a decision or the deliberative process the directors followed in reaching their judgment if there is an adequate record of informed decision making, as opposed to no record or an insufficient one. In most jurisdictions, directors may rely on officers, experts, and business records for facts as long as there is a reasonable basis for such reliance. When directors reasonably rely on others, they are protected from liability if they are misled or given incorrect information. However, a director is not protected if he or she relies on information provided by an officer or expert whom the director has reason to doubt. In addition, directors should not rely on officers or experts for decisions on matters that directors are charged with deciding. When the line between facts and judgments is blurred, which is often the case, directors should not unduly rely on the views of others.

In addition to liability for breach of fiduciary duty and negligence, directors can be liable for intentional torts, such as fraud or misrepresentation, when third persons are injured, even though the actions were on behalf of their institutions. Federal securities laws impose civil liability for fraud or misrepresentation in connection with the sale of securities. Thus, directors must exercise care in the certification of financial statements and collateral because Farm Credit Bank securities are issued on the basis of such certification.

Farm Credit Administration Enforcement Authorities

All System institutions need to be able to attract and to retain qualified and conscientious directors. Directors have obligations to discharge duties owed to the institution, its shareholders, and its creditors. Directors further have obligations to comply with Federal and state statutes, rules, and regulations. When an institution becomes troubled, it is especially important that it have the benefit of the advice and direction of people whose experience and talents enable them to exercise sound and prudent judgment.

However, when directors breach a fiduciary duty, violate the laws and/or regulations governing their conduct, cause or permit persons associated with the institution to violate laws and/or regulations, or act in a way that would adversely affect the institution's condition, the FCA can and will take action to correct the problem and hold the wrongdoer responsible. An institution director, employee, agent, or other person participating in the conduct of the affairs of an institution can be required to refrain from specific acts or to take positive steps to correct the problem. A director (or other party) might also have to pay a penalty for violating the law or failing to take action required in an enforcement document.

The Farm Credit Act Amendments of 1985 granted the FCA enforcement authorities similar to those of other Federal financial regulatory agencies such as the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration. These authorities provide FCA with appropriate power to ensure that System institutions and their related parties comply with laws and regulations and operate in a safe and sound manner.

Enforcement actions served upon an institution or an individual are determined on a case-by-case basis, with consideration given to correcting current deficiencies and preventing future problems. If FCA brings an action, the institution's directors will usually be asked to meet with Agency personnel who will present the enforcement action deemed appropriate for the institution.

Enforcement actions are taken to correct specific problems, and directors are ultimately responsible for ensuring that the institution complies with the action(s). Typically, they specify the steps and time frames the institution must take to correct problems described in Reports of Examination. An action is terminated in one of two ways: (1) by the Agency when it determines that the institution has subsequently complied with the terms of the enforcement action and its overall condition has significantly improved or (2) by a reviewing court.

Enforcement actions can take one of several forms, depending on the seriousness of the situation and the institution's willingness and ability to address the problem(s). The Agency can enter into agreements, issue orders to cease and desist, temporary orders to cease and desist, and orders of removal and suspension. The Agency can also impose civil money penalties.

Agreements

An agreement is a contract between the institution or an individual(s) and the FCA, which commits the institution or individual to taking the specified actions needed to correct a problem. Agreements are used when problems are not severe enough to warrant a more stringent action and the board and management are able and willing to address the agreement's requirements. An institution's board of directors or the specified individual(s) executes the agreement along with an authorized representative of the FCA. If an institution or the individual fails to comply with an agreement, FCA may institute cease and desist proceedings.

Cease and Desist Orders

An order to cease and desist is issued to institutions and individuals when problems are severe. It also may be used when agreements or conditions have been violated that were imposed upon an institution in connection with the granting of an application. An order to cease and desist either specifies affirmative actions that are necessary to correct illegal or unsafe practices or conditions, or requires that such activities be stopped, or both.

All cease and desist proceedings begin with a notice of charges served on the affected institution or party. The notice sets forth allegations regarding the unsafe or unsound practices and/or any violations of law, regulations, written agreements, or conditions that have been identified by FCA. Generally, when a notice of charges is issued to an institution, FCA asks the institution's board to consent to the cease and desist order. A majority of board members, as stipulated in the institution's bylaws, must agree to the order. If the party charged consents to a cease and desist order, the matter does not proceed to an administrative hearing and the order is effective upon execution by the board.

The notice of charges must be answered within 20 days of service. If consent to the order is not obtained, the matter proceeds to a formal hearing before a Federal administrative law judge (ALJ).

After a hearing at which all parties present evidence to the ALJ, the ALJ submits a recommended decision to the FCA Board. It is the Board that ultimately decides whether to issue an order to cease and desist. The party to whom an order to cease and desist has been issued may obtain review of the order by the appropriate United States Court of Appeals. If an order to cease and desist is not complied with, it can be enforced in Federal district court or a civil money penalty action can be initiated. An order to cease and desist remains in effect until terminated by the FCA Board or a reviewing court.

Temporary Cease and Desist Orders

The FCA may issue a temporary order to cease and desist before a cease and desist proceeding is completed when a violation, threatened violation, or unsafe or unsound practice is likely to (1) cause insolvency, (2) cause substantial dissipation of assets or earnings, (3) seriously weaken the condition of the institution, or (4) seriously prejudice the interests of investors or shareholders prior to completion of a cease and desist proceeding. The temporary order can require the institution or a specific party to stop the violation or practice described and/or take corrective action. Unless the temporary order is set aside by court order, it is effective immediately upon being served on the party and remains in force until the effective date of a permanent order to cease and desist, if issued, or dismissal of the charges.

Removals and Suspensions

To remove a director or officer, FCA must determine that the director violated a law or regulation or engaged in an unsound practice or breach of fiduciary duty. The FCA can remove a director or officer if (1) the institution has suffered or probably will suffer substantial financial loss or other damage; (2) the director or officer has received financial gain through a violation or unsound practice; (3) the interests of the institution's shareholders or investors in System obligations could be seriously prejudiced, or (4) the violation, unsound practice, or breach of fiduciary duty involves personal dishonesty or demonstrates willful or continuing disregard for the safety and soundness of the institution.

Directors, officers, or other persons participating in the conduct of the affairs of an institution can also be removed from a System institution if their conduct or practice with respect to another business or System institution (1) has caused a substantial financial loss or other damage; (2) shows personal dishonesty or willful or continuing disregard for the entity's safety or soundness; or (3) shows that the individual is unfit to participate in the conduct of the institution's affairs.

The FCA begins proceedings to remove individuals by serving written notice to them of the Agency's intent. The notice states the grounds for the action and the time and place of a formal administrative hearing. If the person does not consent to removal, the matter proceeds to a hearing. Based on a review of the hearing record and recommendations of the ALJ, the FCA Board decides whether to remove the individual. A removal order may be reviewed by the appropriate United States Court of Appeals. If deemed necessary, the FCA may suspend a director or officer pending completion of a removal proceeding. A suspension may be appealed to the appropriate United States District Court. Once in place, a removal or suspension order prohibits the person from participating in any manner in the affairs of the institution.

The FCA can also suspend or remove an individual charged with or convicted of a crime involving dishonesty or breach of trust punishable by imprisonment for more than 1 year. The FCA must show that the person's continued service is a threat to the interests of the institution's shareholders or investors or threatens public confidence in the institution or the System. Within 30 days of service, the person may request an informal hearing before FCA to modify or terminate the suspension or removal order. A suspension remains in effect until terminated by FCA or until the criminal charge is finally settled. At such time as the conviction is not subject to further appeal, FCA can order the individual's removal from office or prohibit the individual from further participation in the institution's affairs.

Civil Money Penalties

A civil money penalty (CMP) action requires an institution or individual to pay a monetary penalty and can be used alone or in conjunction with other administrative actions. A CMP can be assessed against an institution or individual for violation of the Act, regulations issued under the Act, or an order to cease and desist. The FCA may assess up to $1,100 per day for each day the institution or individual is in violation of a cease and desist order and up to $650 per day for each day a violation of law or regulation continues. Pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended, every Federal agency, including the FCA, must adjust each CMP under its jurisdiction by the rate of inflation at least every 4 years. The CMPs were last adjusted in March 2005.

Before the FCA determines whether to assess a CMP, the offending individual or institution is given an opportunity to submit relevant information that addresses the violation. Once FCA reviews this information, the individual or institution will either receive a notice of assessment or be informed that no assessment will be imposed.

If a notice to assess a CMP is issued, the individual or institution is afforded the same hearing procedures that apply to cease and desist orders. If the evidence supports the allegations, FCA can order the offending party to pay the penalty. The party can seek review of the assessment by the appropriate U.S. Court of Appeals, but if the individual or institution fails to pay the assessment after it becomes final, FCA may refer the matter to the Department of Justice for collection.

This section is included in this handbook so that all directors are fully aware of the potential for a formal regulatory enforcement proceeding and the ensuing personal liability associated with that proceeding. An independent and fully informed board of directors is essential for a well-run institution, and we encourage all directors to know the facts and act responsibly in the discharge of their duties. The following section provides many of the safeguards available for boards.

Some Guiding Principles

The information in this booklet may cause a would-be director to think twice before taking on the responsibility of being a director. To be sure, there are myriad pitfalls to successfully serving as a director on the board of a bank or association. However, the following guiding principles will help. Underlying these principles is the assumption that you are making an honest effort to deal fairly with the institution, to comply with all laws and regulations, and to follow sound practices.

Know the law and regulations. Read and understand the Act and the FCA regulations. (Ask management to provide a hard copy of the information or download it from FCA's Web site at www.fca.gov.)

Act as a fiduciary. As a fiduciary, you must think and act independently and in the best interest of the institution. Always remember that you are the stockholders' representative and are serving their best interests. When acting in an official capacity, your personal interest and those of your family and your associates must be subordinate to the best interest of the institution. You should evaluate issues in terms of the institution's resources and capabilities, the reasonableness of risk and returns, and any potential adverse effects on the institution.

Become well informed. Read financial statements and reports to the board, reports from management, and Reports of Examination with a critical eye. If something is not clear or needs further explanation, ask questions. Always ask yourself whether you have enough information to make an informed decision, and if you do not, find out where you can get the information you need. It is your responsibility to be well informed about the institution, its business environment, and current market practices.

Delegate wisely. Business demands and legal standards that govern an institution's board require you to serve with dedication and vigilance. It cannot be overemphasized that although you may delegate assignments, you may never delegate your responsibilities as a director. While you are encouraged, and in some cases required, to use board committees, the committees do not relieve you of your individual responsibility for the decisions you make and for ensuring that institution operations are properly delegated to people who merit confidence.

Avoid conflicts of interest. Be familiar with the FCA regulations in part 612 addressing conflicts of interest and standards of conduct. Before you act on an institution business matter, ask yourself if you (or members of your family or other close associates) stand to personally gain from a matter. If so, consult with the institution's legal counsel and the institution's standards of conduct officer to determine the appropriate method of dealing with the conflict, including the possibility of recusing yourself from the board deliberations and vote on the matter. When in doubt, the prudent course is likely to be to disclose and abstain from voting on or discussing the matter.

Make use of counsel. Do not hesitate to seek legal counsel when considering internal investigations, application of the business judgment rule, or other matters affecting your role as director.

Select and retain competent management. The most important factor in the success of an institution is the quality of its management. It is rare that the cause of a serious problem or the failure of an institution is other than mismanagement. You must stay keenly aware of management's activities. Your early detection of managerial problems can mean the difference between success and failure of the institution.

Be attentive to risk. The FCA recognizes that FCS institutions must assess and assume carefully calculated risks to be profitable. Your institution must establish an adequate system to manage those risks for its size and complexity of operations. You must be aware of the various risks confronting your institution, the magnitude of those risks, and management's ability to limit risk-taking to an acceptable level consistent with the board's strategy. The board and management must work together to ensure that they adequately identify, measure, monitor, and control risk.

Risk management is a continual process involving the whole organization. Larger institutions may want to establish a separate, independent risk management function. Smaller or less complex institutions can accomplish this objective through the audit committee and active management and board oversight.

Conclusion

Although there are laws and regulations to guide the System in providing the highest quality financial support and related services to a critically important segment of the economy, it ultimately falls to each institution's board of directors to conduct the institution's affairs in a responsible manner. Directors must understand the legal and regulatory mandates that govern the System and make sure that policies are put in place to uphold those mandates while allowing the institution to thrive and serve its members. Their integrity must be unimpeachable, and their dedication to the job unfailing. As the regulator of the System, FCA stands ready to help directors understand and execute their duties. The FCA welcomes your comments and queries.

The board of directors should define its philosophy, objectives, and practices governing compensation and ensure that such compensation practices comply with federal, state, and local laws governing employer and employee relationships. Sound business practices dictate that a compensation program be designed to attract and retain highly qualified employees and to recognize and reward those employees based on their individual performance and based on institution goals and objectives. The board of directors should determine if the institution has sufficient earnings capacity to cover both its compensation programs and other costs of operations. In those instances where the institution provides deferred compensation to officers or employees, the future financial impact of those programs should also be determined and addressed in the institution's financial planning.

Employee Compensation

FCA regulations §§ 620.31 and 630.6(b) require each board of directors to establish and maintain a compensation committee to review the compensation policies and plans for senior officers and employees and to approve the institution's overall senior officer compensation program. Characteristics of an appropriate compensation program include the following:

- A board-approved compensation policy that incorporates a purpose, objective, delegations, exceptions to policy, and reporting requirements.
- Salary ranges based on the competitive market.
- Salaries that reflect the relative value of each position to the institution.
- Salaries and incentive programs that motivate employees to attain higher levels of performance and achieve business plan goals and objectives.

The board of directors may adopt an incentive compensation program to encourage improved or continued performance and the accomplishment of the institution's strategic goals and objectives. An effective incentive program requires careful deliberation by the board about its cost-benefit, and the board should also closely monitor the impact of the incentive program on the achievement of business and capital plan goals and objectives.

An effective compensation administration is complemented by written job descriptions and a system for assessing jobs and assigning them to salary ranges. Some institutions might use consulting firms, a personnel department, or a panel of experts to evaluate positions. Any of these approaches is appropriate as long as it results in internal equity and as long as the differences between grades or compensation levels are linked to differences in position requirements.

To establish the appropriate salary range for employees, including the CEO, institutions may want to use salary surveys to compare their compensation rates with similar positions (benchmark positions) in comparable organizations. Benchmark comparisons allow institutions to ensure that the salary scale for each position is competitively priced compared with jobs of similar responsibility and complexity in other institutions of similar size, function, and operations.

A board of directors should ensure that the basis for salary adjustments is substantiated by independent studies using objective data from the marketplace. Farm Credit banks should be mindful that Section 5.19 of the Act requires FCA to include in the examinations of Farm Credit banks an analysis of the compensation paid to the CEOs and the salary scales of the employees.

Bank Director Compensation

FCA regulation § 611.400(d) also requires banks to have policies addressing bank director compensation. A Farm Credit bank board of directors must establish a policy governing fair and reasonable compensation to directors for their services to the institution. The critical elements of the policy include methodology for determining each director's rate of compensation and the exceptional circumstances under which the board would pay additional compensation for any of its directors as authorized by FCA regulation § 611.400(c).

Annually, the FCA notifies each Farm Credit bank's board chairperson and the CEO of the maximum bank director compensation for the ensuing calendar year. Section 4.21 of the Farm Credit Act establishes a maximum annual compensation for bank directors, which is annually adjusted to reflect the change in the Consumer Price Index (CPI). Section 4.21 allows FCA to adjust the compensation level if it will adversely affect the safety and soundness of the bank or to waive the compensation limit under exceptional circumstances.

On December 15, 2005, the FCA Board made a one-time adjustment to the current limitation on bank director compensation. Farm Credit bank directors now have a maximum compensation level of $45,740, adjusted for the CPI. When making this one-time adjustment, the FCA Board advised bank boards to modify their written policies on director compensation, including an explanation of the factors that would justify higher levels of compensation.

The FCA Board also advised bank boards to be judicious when exercising the existing 30 percent waiver authority in FCA regulations §§ 611.400(c) and (d). Approved exceptional circumstances that might justify exceeding the statutory limit could include mergers, consolidations, other corporate restructurings, and joint management proposals and joint strategic planning projects between System banks. The FCA Board advised banks using the waiver to fully identify in the annual report both the specific extraordinary event(s) and time or effort warranting additional compensation. An individual justification must be made for each director receiving additional compensation under the waiver authority.

Appendix B: Information Available

The FCA makes a variety of information about FCS institutions available to the public on the FCA Web site, including the periodic data that FCS institutions are required to submit to FCA about their operations. The required reporting includes financial data that FCS institutions submit quarterly in the form of Uniform Call Reports (UCR) and the annual data that FCS institutions submit pertaining to lending activities to young, beginning, and small farmers and ranchers (YBS) for the past year.

The UCR data are located on the FCA Web site under "View Call Reports," which is listed as an option under the "FCA Institutions" category. Nearly all UCR data are available to the public; however, some of the data are considered proprietary and, as such, are not available to the public. However, an FCS institution's management can access the proprietary data for its institution by logging in to the private area of the FCA Web site.

The UCR data are provided in a variety of reports. Most of the reports available are the quarterly UCR reports submitted by the individual FCS institutions. In addition, FCA has developed several analytical trend or comparison reports using the UCR data: the Uniform Performance Report (UPR), the Uniform Peer Performance Report (UPPR), the Six-Quarter Trend Report, the Six-Year Trend Report, and the Institution Comparison Report. Most reports are available for active and inactive institutions back to March 1989.

Reports

The UPR. This report presents an institution's financial statement information in various relational formats, including key financial ratios, percentages, and dollar amounts. The report shows a condensed balance sheet and income statement, as well as information on capital, assets, earnings and profitability, and liquidity. Four reporting periods are represented—the current quarter, the same quarter 12 months earlier, and the last 2 yearends.

The UPPR. This tool facilitates analytical review of an institution's performance by providing peer averages and percentile rankings. The purpose of the UPPR is to provide a comparison of an institution's condition and performance with that of other institutions of similar asset size. UPPRs are available from 1993 to the present.

Six-Quarter and Six-Year Trend Reports. These reports are identical to the UPR in format and content; however, the information is presented in six consecutive reporting periods to facilitate trend analysis.

Institution Comparison Report. This report is also identical to the UPR in format and content, but it presents the information for the specified reporting period for up to six institutions chosen by the user.

YBS Report. The annual YBS data are also made available to the public on the FCA Web site in the same location as the UCR data. The YBS report presents the institution's outstanding lending activity in each category, as well as the lending activity for the specified year. It also includes a comparison of the lending activity for each category with the entire portfolio. The YBS reports present data for only one reporting period and go back only to 1999.

Appendix C: Financial Condition and Key Financial Ratios

A director must have an in-depth understanding of the institution's financial condition and risk position. Regular reports showing the institution's financial performance help directors assess the institution's financial condition, determine whether the risk taken by the institution is consistent with the board's philosophy, and identify potential warning signs in current operations. For financial information to be useful, it must be timely, concise, and presented in an easily understood format. Financial reports should present information regarding current operations and financial trends in the areas of credit risk, earnings, liquidity risk, and interest rate risk (IRR). Further, they should periodically include comparisons to the budget and the board's business plan goals and objectives, as well as benchmarking between the institution and its peers. In all such comparisons, significant deviations should be explained by management.

To assist directors and management of FCS institutions, the FCA has developed two reports that directors may access on the FCA Web site: the Uniform Performance Report (UPR) and the Uniform Peer Performance Report (UPPR). These reports are based on the Call Report data that each institution submits to FCA each quarter. The UPR and the UPPR include various data and financial ratios in the areas of capital, asset quality, earnings, liquidity, and sensitivity. In reviewing these reports, directors should first review the "Guide for the Use of the Uniform Performance Report and the Uniform Peer Performance Report," which will soon be available on the FCA Web site. This guide contains basic guidelines for using the UPR and the UPPR, including definitions of the various data elements and calculated ratios.

There are two levels of access to the UPR and the UPPR—a private one and a public one. The public version includes only data that are not exempt under the Freedom of Information Act. FCS institutions have passwords that allow access to the private versions of the UPR and the UPPR for their institutions. FCA encourages directors to request that management periodically provide reports on the information in the private versions of the UPR and the UPPR. We also note that individual financial ratios can be calculated using various methodologies. Therefore, ratios presented in the UPR and the UPPR could differ from the ratios that an institution's management provides to its board. Directors should ask management to explain significant differences.

In addition to the UPR and the UPPR, FCA's Web site also includes the Six-Quarter Trend Report and the Six-Year Trend Report. These reports are similar to the UPR and the UPPR, but they provide different time perspectives (six quarters, or six years, of data and ratios). They are useful in evaluating trends in the various ratios over an extended period.

FCA's *Examination Manual* (also available on FCA's Web site) contains two documents that discuss how FCA assigns ratings to individual institutions:
EM-135—"Financial Institution Rating System (FIRS)."
EM-199—"Supplement 5—FIRS Guide."

EM-135 discusses the system that FCA examiners use to assign a composite rating to an institution, as well as component ratings for capital, assets, management, earnings, liquidity, and sensitivity. The FIRS guide is more specific in that it defines the characteristics of each rating and the financial ratio benchmarks that FCA examiners use to assign the composite and component ratings.

Financial ratios (whether internal to the institution or those in the UPR, the UPPR, and the FIRS guide) are useful indicators of risk and performance in multiple areas of operations. The sections below discuss the primary examination areas with reference to some of the more important financial ratios boards use to monitor their institutions. Most of the ratios noted in the sections below are included in the UPR and the UPPR, and many are used in the FIRS guide. Definitions of the ratios are also found in the "Guide for the Use of the Uniform Performance Report and the Uniform Peer Performance Report."

Capital Adequacy

The responsibilities of a director include ensuring that the institution has sufficient capital to accomplish its mission, goals, and objectives. Capital provides a cushion to absorb fluctuations in net income, provides a measure of assurance to investors and stockholders regarding the institution's stability, supports asset growth, and contributes to the institution's earnings base. FCA regulation § 615.5200 requires boards of directors to establish, adopt, and maintain formal written capital adequacy plans as part of the institutions' financial plans. The regulation also requires directors of FCS institutions to determine the amount of total capital, core surplus, total surplus, and unallocated surplus needed to ensure the institutions' continued financial viability and to provide for growth necessary to meet the needs of their borrowers. The minimum capital standards specified by the regulations are not meant to be adopted as the optimal capital level in an institution's capital adequacy plan.

The board of directors is charged with establishing an appropriate optimum capital goal based on the institution's particular circumstances and risk profile. An institution's capital needs depend on its operating environment, portfolio risk, growth prospects, and other risks that exist within the institution. The board must carefully monitor all components of capital to ensure an appropriate balance between shareholder ownership and unallocated surplus. Determination of the appropriate optimum capital goal should result from analysis conducted as part of the business planning process and should be reflective of the risks faced by the institution—both existing and planned.

Key Capital Adequacy Measures

Regulatory Capital Ratios: FCA regulations define and set minimum regulatory levels for the following ratios:

- Permanent capital ratio
- Total surplus ratio
- Core surplus ratio
- Net collateral ratio (banks only)

The first three of these regulatory ratios generally express various components of capital as a percentage of risk-adjusted assets, and the three are organized by the quality of capital included. The core surplus ratio contains the highest quality of capital, the capital with greater "staying power" when the institution encounters trouble. These ratios provide insight into the composition of capital, the financial strength of the institution, and the ability to fund future growth. The net collateral ratio (banks only) is essentially a capital leverage ratio that also eliminates any double-leveraged capital between a district bank and its affiliated associations.

Adverse Assets to Risk Funds: This measure compares the risk in the loan portfolio and other property owned to the institution's permanent capital base, plus its allowance for losses on loans. The ratio measures the risk-bearing capacity and threat to the institution's capital base presented by the quality of assets. Criticized or nonaccrual assets can be substituted in the numerator of this ratio for alternative perspectives.

Potential Warning Signs

- A declining capital position, below the board's optimum capital goal or capital levels approved in the business plan.
- Asset growth exceeding the institution's capital growth.
- Significant increases in portfolio risk as evidenced by the level and trends of criticized, adverse, and nonaccrual assets.
- Capital ratios significantly below peer averages.
- Capital levels approaching the institution's minimum regulatory capital requirements.

Earnings

An adequate and reliable earnings stream is fundamental to the maintenance of a safe and sound institution. Earnings represent the institution's first line of defense against capital depletion due to credit losses, IRR, and other operational risks. The viability of an institution often depends on its ability to earn an appropriate return on its assets and capital. The board's philosophy on earnings should be clearly documented in the institution's business and capital plans. The earnings philosophy should address the composition of income, be reflective of the competitive environment, and address the need to generate an acceptable return on assets. The directors' review of earnings should focus on the quantity, quality, and trend of earnings. Institutions with good earnings performance can grow, remain competitive, augment capital, and provide a return to shareholders through patronage distributions. When an institution's quantity or quality of earnings diminishes, the cause is usually related to excessive or inadequately managed credit risk or IRR, or high operating costs. The quality of earnings may also be affected by reliance on extraordinary or nonrecurring events.

Key Earnings Ratios

Return on Average Assets: Net income divided by average assets. Measures how efficiently the institution uses its assets to generate earnings.

Net Interest Margin: Interest income less interest expense divided by average earning assets. Reflects funding costs, loan pricing, and investment practices.

Operating Expenses to Average Total Loans: Total operating expenses divided by average total loans. Measures operating efficiency in terms of the relationship between the operating costs and the loan assets.

Return on Average Equity: Net income divided by average equity capital. Measures the return on the stockholder's investment.

Loanable Funds to Earning Assets: The percentage of earning assets that are not funded with interest-bearing debt. Loanable funds (earnings assets less interest-bearing liabilities) are a measure of the earnings capacity of the institution.

Potential Warning Signs

- Large variances from budgeted amounts on income and expense items.
- Significant differences in return on assets, return on equity, or net interest margin from prior periods.
- Inconsistent or unstable earnings performance.
- Declining levels of net interest income.
- Unfavorable comparisons of key earnings ratios with those of peer group.

Liquidity

Liquidity represents the ability to fund assets and meet obligations as they come due. Liquidity is critical to the ongoing viability of any institution and is among the most important management activities at a financial institution. The principles of liquidity management used by banks differ substantially from those used by associations. A bank should seek to maintain sufficient cash flow to fund operations, service debts, meet commitments to borrowers, and provide for funding contingencies; an association must maintain access to funding from the creditor bank. Sufficient liquidity is essential to accommodate expected and/or unexpected balance sheet fluctuations and to provide for contingencies.

The board of directors should maintain policies and strategies related to the management of liquidity. In addition, banks should have contingency plans in place that address the strategy for handling liquidity crises or unanticipated funding events. The FCS's primary source of liquidity is its access to debt capital markets using its government-sponsored enterprise status. The banks obtain their principal sources of funding and liquidity through debt issued in the capital markets through the Federal Farm Credit Banks Funding Corporation. Secondary sources of liquidity are available through investment management in accordance with FCA regulations. Other sources of liquidity include lines of credit from commercial lenders. These lines of credit can provide an alternative source of liquidity in normal periods but can become expensive or quickly dissipate in an adverse operating environment.

The principal source of liquidity for associations is funding from the bank. The board must ensure that the association complies with the general financing agreement for funding. Failure to comply with the terms of the general financing agreement could result in increased interest costs, additional fees, penalties, increased oversight, or suspension of funding. Each of these consequences could increase the cost of borrowing and impact profitability and ultimately the cost to borrowers.

Liquidity Ratios/Measurements

Days of Liquidity: The number of days-of-maturing obligations that could be funded by the liquid investments at any given point. FCA regulation § 615.5134 requires FCS banks to maintain a liquidity reserve sufficient to fund 90 days of the principal portion of maturing obligations and other borrowings of the bank at all times.

CIPA (Contractual Interbank Performance Agreement) Score: An agreement between all FCS banks and the Federal Farm Credit Banks Funding Corporation (as scorekeeper) that measures and monitors each bank's/district's quarterly financial condition and performance. The CIPA score incorporates measurements of capital, asset quality, earnings, liquidity, and sensitivity (IRR). The agreement provides for economic penalties against individual banks if specified minimum thresholds of performance are not met.

Association Performance Scores: Performance scores that have been developed by several district banks for their associations; they are similar to the CIPA scores used by the district banks. Association directors should fully understand any performance scores that may be incorporated into covenants of the association's general financing agreement with the district bank.

Quality of Assets Supporting the Direct Loan: A measure applicable to associations only; it provides a measurement of the quality of assets that support the direct loan from the funding bank. Acceptable assets as a percentage of the direct loan measures the coverage provided by high-quality assets available to secure the direct loan with the institution's funding bank. Loans graded "acceptable" and "special mention" and accrual assets as a percentage of the direct loan are additional measures of the quality of assets supporting an association's direct loan.

Potential Warning Signs

- Real or perceived negative developments in either internal or external operating environments.
- A decline in asset quality (resulting in a decline in the ratios that measure quality of assets supporting debt).
- A decline in earnings performance or projections.
- Downgrades or announcements of potential downgrades of the System's or an institution's credit rating by rating agencies.
- Days-of-liquidity approaching the regulatory minimum.
- Wider spreads on the debt issuance compared with other government-sponsored enterprises.

Sensitivity to Market Risk

Sensitivity to market risk refers to the risk to an institution's earnings or capital resulting from changes in market interest rates. Changes in interest rates can adversely affect a financial institution's earnings and capital. IRR is an inherent risk for financial institutions and can become excessive unless properly managed. The institution's IRR management program comprises the policies, procedures, and systems used to manage this risk. The effectiveness of an institution's IRR management program will determine whether additional capital may be required to compensate for excessive risk or whether the level of exposure poses supervisory concerns.

The following FCA regulations set forth the responsibilities boards of directors have regarding IRR management:

- FCA regulation § 615.5135 requires the board of directors of each FCS bank to develop and implement an IRR management program and requires the board to adopt an IRR management section of an asset/liability management policy that establishes IRR exposure limits, as well as the criteria to determine compliance with these limits.
- FCA regulation § 615.5180 requires the board of directors of each FCS bank to develop and implement an IRR management program tailored to the needs of the institution and consistent with the requirements set forth in regulation § 615.5135.
- Regulation § 615.5181 states that FCS bank boards are responsible for providing effective oversight of the IRR management program and must be knowledgeable of the nature and level of IRR taken by the institution.

- FCA regulation § 615.5182 requires any association with IRR that could lead to significant declines in net income or in the market value of capital to comply with the requirements of § 615.5180 and § 615.5181.

The board of directors must ensure that management effectively identifies, measures, monitors, and controls IRR. The complexity and level of risk should determine the sophistication of the institution's IRR management program. At most associations, the bank, through the transfer pricing program, limits the IRR that an association can assume. As a result, the sophistication and analysis required to assess risk will be less at most associations. Nevertheless, the risks assumed should be clearly documented, and the board should monitor the risks to ensure conditions do not change.

More complex institutions, such as banks or associations assuming more IRR, will need more formal, detailed IRR management programs. Management should establish sound controls and analyze all major risk exposures. The board of directors should understand the major risks that are being taken and ensure that controls surrounding the IRR management program are sound. At these institutions where the IRR is more complex, a thorough independent review of the IRR management program should be performed periodically. FCA recommends that directors unfamiliar with IRR concepts obtain training in this area.

Sensitivity Ratios/Measurements

Gap Analysis: The difference between assets and liabilities that mature or reprice within a given time is known as the periodic gap. An institution's gap position indicates how interest rate changes may affect its net interest income. If more assets than liabilities mature or reprice in the defined period, then the institution would have a positive gap for that period. Generally speaking, an institution with a positive gap position would be exposed to falling interest rates because as interest rates declined, more assets than liabilities would reprice at lower rates. Conversely, at a negatively gapped institution, net interest income would be adversely affected by increases in market interest rates since more liabilities would reprice more quickly. Although gap reports can be useful in understanding IRR exposures, institutions with significant risk exposure or complex financial instruments should not rely solely on gap analysis for establishing IRR exposure limits or measuring exposure to those limits.

Duration Analysis: The term *duration* refers to a measurement of the sensitivity of an asset's or liability's value to movements in interest rates. By measuring the duration of assets, liabilities, and off-balance-sheet positions, duration measures such as the "duration of equity" or "duration gap" can be used to analyze the effects of interest rate changes on the value of an institution's assets, liabilities, and capital position.

Net Interest Income (NII) and Market Value of Equity (MVE) Simulations: These simulations show the percentage change in NII and MVE for a given change in market interest rates. Income simulation is used to forecast how net interest income changes in response to changes in interest rates. MVE simulation focuses on possible changes in the market value of a bank's assets, liabilities, and off-balance-sheet items due to interest rate movements and the impact these changes have on an institution's capital position. MVE simulation is especially important in large and complex institutions managing significant sources of IRR. The reliability of the measurement system depends heavily upon the quality of the data and various assumptions used in the model; therefore, close attention to these areas is warranted.

Potential Warning Signs

- Significant volatility in the institution's net interest income.
- Noncompliance with the board's established limits.
- Increasing amount of, and trend in, aggregate IRR exposure.
- High or increasing volume of assets with embedded options, such as fully prepayable fixed-rate loans or investments.
- Lack of timeliness and clarity in management reports regarding the identification and quantification of the major sources of IRR.
- Lack of an independent review or audit of the IRR management process.

Appendix D: Examination and Supervision Based on Institution Risk

Historically, institution risks have been concentrated in traditional lending activities. However, the complexity of institutions' consolidated risk exposure has increased over the years as the variety of lending products has increased, as the diversity of geographic areas served by FCS institutions has increased, and as delivery systems have evolved. Because of this complexity, institution management must evaluate, control, and manage risk according to its significance. Consolidated risk assessments should be a fundamental part of managing the institution.

Because of the variation and complexity of risks in the institutions, FCA employs a risk-based examination and supervisory approach. Its examiners do not attempt to restrict risk-taking but rather to determine whether institution management identifies, understands, and controls the risks they assume. As an organization grows more diverse and complex, its risk management processes must keep pace. When risk is not properly managed, FCA will direct an institution's board and management to take corrective action. In all cases, FCA's primary concern is for the institution to operate in a safe and sound manner and to maintain capital commensurate with its risk.

Risk Definition

For purposes of the discussion of risk, FCA evaluates institution risk largely relative to its impact on capital and earnings. From an examination and supervisory perspective, risk is the potential that events, expected or unexpected, may have an adverse impact on the institution's capital or earnings.

The existence of risk is not necessarily reason for concern. Even the existence of high risk is not necessarily a concern as long as management exhibits the ability to effectively manage that level of risk. To put risks in perspective, examiners will evaluate whether the risks an institution undertakes are, either individually or collectively, warranted. Generally, a risk is warranted when it is identified, understood, measured, monitored, and controlled. It should be within the institution's capacity to readily withstand the financial distress that such risk could cause. Unwarranted risks (that is, those not understood, measured, controlled, or backed by adequate capital to support the activity) will need examination and supervisory attention. Examiners will communicate to management and the directorate the need to mitigate or eliminate excessive risks. Appropriate institution actions may include reducing exposure, increasing capital, or strengthening risk management processes.

As discussed in the following paragraphs, FCA has defined seven categories of risk for institution examination and supervision purposes. These risks are credit, interest rate, liquidity, operational, compliance, strategic, and reputation. These categories are not mutually exclusive; any product or service may expose the institution to multiple risks. In addition, they can be interdependent. Increased risk in one category can increase risk in other categories.

Credit Risk: The current and prospective risk to earnings or capital arising from an obligor's (i.e., a borrower's) failure to meet the terms of any contract with the institution or an obligor's failure to perform as agreed. This risk is found in all activities where success depends on counterparty, issuer, or borrower performance. It arises whenever institution funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Interest Rate Risk (IRR): The current and prospective risk to earnings or capital arising from movements in interest rates. This risk primarily arises from differences between the timing of rate changes and the timing of cash flows (repricing or maturity mismatch risk); from changing rate relationships among different yield curves affecting various products (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-related options embedded in assets and liabilities (options risk). Other secondary factors can also impact an institution's IRR profile.

Liquidity Risk: The current and prospective risk to earnings or capital arising from an institution's inability to meet its obligations when due without incurring unacceptable losses. This risk includes the inability to manage unplanned decreases or changes in funding sources. It also arises from the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value. Sufficient liquidity is essential to accommodate expected and unexpected balance sheet fluctuations and to provide funds for growth.

Operational Risk: The current and prospective risk to earnings and capital arising from problems with service or product delivery. This risk transcends all divisions and products in a financial institution, including senior management, treasury, corporate accounting, credit risk, loan underwriting, and internal audit. It is a function of internal controls, information technology, employee integrity, and operating processes. Operational risk exists in all products and services; it arises on a daily basis in all financial institutions as transactions are processed and services are provided.

Compliance Risk: The current and prospective risk to earnings or capital arising from violations of, or noncompliance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain products, such as consumer loans, or activities, such as borrower rights, are inappropriately applied. This risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to diminished reputation, customer flight, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

Compliance risk is often overlooked because it blends into operational risk and transaction processing. A portion of compliance risk is sometimes referred to as legal risk. This is not limited solely to risk from the failure to comply with consumer protection laws; it encompasses all laws, as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of the financial services industry.

Strategic Risk: The risk to earnings or capital arising from inadequate direction and control, adverse business decisions, lack of achievement in goals and objectives, lack of adherence to policy direction, or lack of responsiveness to industry or regulatory changes. This risk is a function of the compatibility of the board's strategic goals, strategies to achieve those goals, and accountability for achieving the goals. The resources needed to carry out business strategies are both tangible and intangible; they include communication channels, operating systems, delivery networks, and managerial capabilities. An institution's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.

Reputation Risk: The risk to earnings and capital arising from negative public opinion. Negative public opinion can impact an institution's ability to maintain creditability as a viable institution, as well as its ability to establish new relationships with existing FCS institutions or other financial institutions. It can also affect an institution's ability to continue servicing existing customers. Although sometimes difficult to quantify, reputation risk can expose an institution to litigation, financial loss, or a decline in the customer base. The potential for reputation risk exposure is always present; therefore, the board and management must exercise an abundance of caution in dealing with customers and the community.

Appendix E: IT Governance

The pervasive use of technology in FCS institutions has created a critical dependence on information technology (IT), which calls for a specific focus on IT governance. Boards of directors of FCS institutions are responsible for an effective enterprise governance framework that includes IT. Like other governance subjects, IT governance is the responsibility of the board of directors and executives of System institutions.

The board of directors should approve IT-related plans, policies, and major expenditures. Board members should be aware of key IT topics, such as the IT and information security policies, data center concepts and activities, and IT-related risks. The institution's board should have an understanding of the IT strategy's infrastructure and components. In addition, the board should be aware of key system development and acquisition projects and how they support and affect overall corporate strategies, objectives, and short- and long-term budgets. To carry out their responsibilities, board members should do the following:

- Ensure management has an effective strategic planning process that aligns IT strategy with enterprise strategy.
- Adopt IT policies sufficient to ensure the institution's safety and soundness, and compliance with law, regulations, and IT essential practices.
- Insist that an IT control framework be adopted and implemented.
- Require regular reporting on IT system functionality and security.
- Identify the role and resources of the internal auditor with respect to IT use and security.

Many boards use committees that oversee critical areas of the institution to assist them with carrying out their governance duties. An FCS institution's board of directors may choose to delegate the responsibility for monitoring IT activities to a senior management committee or IT steering committee. The board should define the responsibilities of the committee within a charter. The committee's mission should be to assist the board in overseeing the institution's IT-related activities. The committee should consist of representatives from senior management, the IT department, and major end-user departments. Members do not have to be department heads but should know IT department policies, practices, and procedures. Each member should have the authority to make decisions within the group for his/her respective areas.

In addition, the committee should ensure that the board has the information it needs to make informed decisions that are essential to achieve the objectives of IT governance. Those objectives are the following:

- The alignment of IT and the business.
- The delivery of value by IT to the business.
- The sourcing and use of IT resources.
- The management of IT-related risks.
- The measurement of IT performance.

The overview by the committee enables the board to make decisions without becoming involved in routine operations. The committee should provide general reviews to the board regarding major IT projects. The committee helps to ensure business alignment, effective strategic IT planning, and oversight of IT performance. The committee may also perform the following:

- Oversee the development and maintenance of the IT strategic plan.
- Approve vendors used by the organization and monitor their financial condition.
- Coordinate priorities between the IT department and user departments.
- Review the adequacy and allocation of IT resources in terms of funding, personnel, equipment, and service levels.

Appendix F: Conflicts of Interest

Having a reputation for honest dealings is important. Having the good opinion of the internal community—the employees and officers—is critical for effective corporate governance. Even more important is to have the good opinion of those outside the corporation.

To establish and maintain an institution's reputation for customer trust and honest dealings with business partners, certain disclosures are expected. In general, it is a duty of the board, as fiduciary agent for the institution's stockholders, to keep stockholders fully informed of any activities or business affiliations by the board, individually or collectively, and/or its officers that might affect the decisions they make or actions they take on behalf of the institution.

In addition, to carry out legislative requirements contained in the Act, FCA regulations require the disclosure of certain information to stockholders and other interested parties.

Directors

Each director must disclose in the institution's annual report any outside business affiliations in which he or she serves as a director or senior officer. Moreover, directors must disclose all cash and noncash compensation received from third parties when acting in their official capacity. Noncash compensation includes gifts, such as coffee, T-shirts, and meals, unreimbursed payments for trips, and use of property. To facilitate reporting of cash and noncash compensation, FCA regulations provide a $5,000 threshold. The threshold is applied to the combined value of

1. cash and noncash compensation from a third party;
2. noncash compensation from the employing institution; and
3. institution perks.

Senior Officers

Senior officers must disclose in the annual report any business affiliations with outside entities in which they serve as directors or senior officers. Senior officers must also report any cash or noncash compensation received from third parties when acting in their official capacity. The compensations of all senior officers, plus any other officers whose compensations are among the five highest paid by the institution, must be reported in the aggregate in the annual report. However, the CEO's compensation must be reported on an individual basis. Associations are given an option of reporting this information in the annual meeting information statement (AMIS) if an appropriate notation is made in the annual report. In addition, the annual report (or the AMIS) must contain a statement that the individual compensation of any senior officer may be requested by a stockholder of the institution and received without delay or adverse consequences. By regulation, the AMIS is a public document and must be available for public inspection at each institution's offices.

Appendix G: Nominating Committees

The nominating committee has the ability to help stockholders shape the composition of the board. The composition of the board should represent as nearly as possible all areas of the institution's territory and as nearly as possible all types of agriculture practiced within the territory. It should also represent a combined skill set that facilitates the board's ability to address the issues that it faces and expects to face.

The nominating committee's responsibility is to identify, evaluate the qualifications of, and nominate at least two willing and qualified candidates for each open director position to stand for election by the institution's board of directors. The evaluation should also consider any known obstacles preventing a candidate from performing the duties of the position. If the nominating committee is unable to identify more than one willing and qualified candidate for an open director position, the nominating committee must provide a written explanation to the board of its efforts to locate at least two willing candidates for each open director position, including its reasons for disqualifying any other candidate(s), if the disqualification resulted in fewer than two nominees. A summary of the nominating committee's efforts must be disclosed to voting stockholders in the annual meeting information statement (AMIS).

The nominating committee's independence is critical to the success of the cooperative because it ensures that representatives of the voting stockholders, not the current board members or institution management, choose the slate of candidates. While it is the nominating committee's responsibility to find candidates who meet or, with director training, could meet the qualifications the board desires, other eligible stockholders may seek nomination without regard to desirable director qualifications. Hence, floor nominations may result in director candidates who do not possess those qualifications. Only associations are required to allow floor nominations, but banks must inform stockholders if they will accept floor nominations.

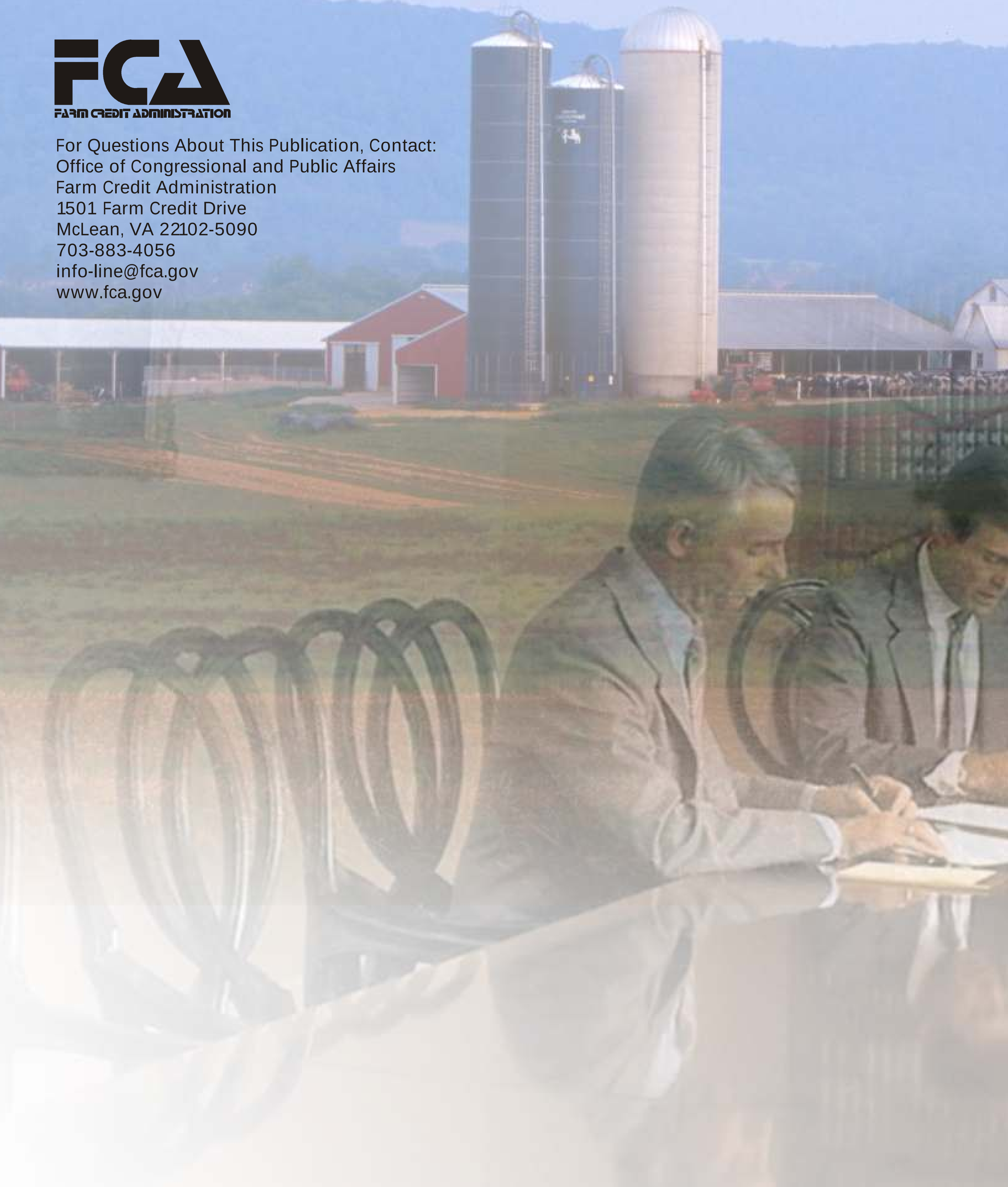
Each bank and association board of directors must establish and maintain a policy identifying desirable qualifications for directors. The policy must explain the type and level of knowledge and experience desired for board members and explain how those qualifications were identified. The policy must be periodically updated and provided to the institution's nominating committee. The desirable qualifications must be adequate to meet the board's needs but broad enough to allow the nominating committee to identify at least two willing and qualified candidates for each open position without undue burden or difficulty.

Composition. The voting stockholders of each Farm Credit bank and association must elect a nominating committee composed of at least three stockholders who are independent of the institution's board, management, and staff. This requirement precludes an institution's directors, director candidates, employees (including officers), and agents from serving on the committee. It does not preclude former directors from serving in this capacity as long as they remain voting stockholders of the institution. The institution should strongly discourage stockholders who are family members of candidates from serving on the nominating committee.

Election of Nominating Committee Members and Term of Office. Section 4.15 of the Act requires each association to elect a nominating committee at the annual meeting to serve for the following year. Banks do not have to elect a nominating committee at the annual meeting, so they have more flexibility in determining when and how long nominating committee members serve. However, it is incumbent upon banks as well as associations to ensure that the selection of nominating committee members is fair and open to all voting stockholders.

Impartiality. Nominating committees must conduct themselves in the impartial manner prescribed by the policies and procedures adopted by their institution under FCA regulation § 611.320 of the Act. The provisions of § 611.320(b) explain the limitations on the assistance that employees may offer the nominating committee. Directors, employees, and agents should not be present when the committee deliberates and votes on its slate of candidates. Directors, employees, and agents are not allowed to make oral or written statements intended to influence the choice of nominees.

Resources. The bank or association must provide the nominating committee a current list of institution stockholders, the most recent bylaws, the current policy on desirable director qualifications, and a copy of the policies and procedures that the bank or the association has adopted ensuring impartial elections. Upon the request of the nominating committee, the institution must also provide a summary of the current board's self-evaluation. The bank or association may require a pledge of confidentiality by committee members before releasing evaluation documents.



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