

OFFICE OF
INSPECTOR GENERAL

Report of Audit

Approval Process of
Funding Corporation Debt
Issuances
A-11-02

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Auditor-in-Charge



September 12, 2011

FARM CREDIT ADMINISTRATION

Farm Credit Administration

Office of Inspector General
1501 Farm Credit Drive
McLean, Virginia 22102-5090



September 12, 2011

The Honorable Leland A. Strom, Chairman and Chief Executive Officer
The Honorable Kenneth A. Spearman, Board Member
The Honorable Jill Long Thompson, Board Member
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

Dear Chairman Strom and Board Members Spearman and Long Thompson:

The Office of the Inspector General completed an audit of the Farm Credit Administration's (FCA or Agency) approval process of Farm Credit System (FCS or System) debt issuances by the Federal Farm Credit Banks Funding Corporation (Funding Corporation). The objective of this audit was to assess whether FCA's approval process of Funding Corporation debt issuances is operating efficiently and effectively and in compliance with applicable guidelines.

The results of our audit revealed that FCA is fulfilling its responsibility outlined in the Farm Credit Act of 1971, as amended. FCA developed clearly defined approval criteria and methodically evaluated the Funding Corporation's funding requests. The approval process was efficient and effective for approving funding requests and provides a preventive control mechanism before system-wide debt is issued. We made suggestions throughout this audit, but did not make any formal recommendations.

We conducted the audit in accordance with Government Auditing Standards issued by the Comptroller General for audits of Federal organizations, programs, activities, and functions. We conducted fieldwork from February through August 2011. We provided a discussion draft report to management on August 25, 2011.

We appreciate the courtesies and professionalism extended to the audit staff. If you have any questions about this audit, I would be pleased to meet with you at your convenience.

Respectfully,

A handwritten signature in black ink that reads 'Carl A. Clinefelter'.

Carl A. Clinefelter
Inspector General

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Executive Summary

The Office of Inspector General (OIG) performed an audit of the Farm Credit Administration's (FCA or Agency) approval process of Farm Credit System (FCS or System) debt issuances by the Federal Farm Credit Banks Funding Corporation (Funding Corporation). The objective of our audit was to assess whether FCA's approval process of Funding Corporation debt issuances is operating efficiently and effectively and in compliance with applicable guidelines.

The results of our audit revealed that FCA is fulfilling its responsibility outlined in the Farm Credit Act of 1971, as amended (Farm Credit Act). FCA developed clearly defined criteria and methodically evaluated the Funding Corporation's funding requests. Due to the short term nature of discounts notes, the approval process for discount notes is based on a program approval with conditions that includes a ceiling of \$60 billion outstanding. The approval process for unscheduled bonds and designated bonds was efficient and effective for approving funding requests and provides a preventive control mechanism before FCS bonds are issued. The Agency's approval process is consistent with the process outlined in documented Agency policies and procedures. Key personnel involved in the funding approval process are dedicated to researching and responding appropriately to funding requests. Overall, we found that FCA is proactive in monitoring significant financial data and market events.

Our audit did not reveal any significant deficiencies. Therefore, we did not make any formal recommendations.

Introduction and Background

The Farm Credit Act provides the FCS with the ability to issue notes, bonds, debentures, or other similar obligations with approval of the FCA.¹

The FCS is a Government-Sponsored Enterprise (GSE) created by Congress in 1916 to provide American agriculture with a dependable source of credit. The FCS is a nationwide network of cooperatively organized banks and associations that are owned and controlled by their borrowers. FCS banks obtain a majority of their funds for loans through the issuance of Farm Credit Debt Securities (FCDS) since they are precluded from taking deposits.

The Funding Corporation is owned by the FCS banks and its primary function is to market securities, mostly bonds and discount notes, for the FCS banks. These securities are offered by the Funding Corporation through a nationwide group of securities dealers and dealer banks. Subject to FCA approval, the Funding Corporation has the responsibility for establishing the amounts, maturities, rates of interest, terms, and conditions of participation by the FCS banks in each issuance of FCDS².

¹ Section 4.2(b) – (d), 12 U.S.C. 2153 (b) – (d). An individual bank's issuance of debt under section 4.2(a) of the Act does not require FCA approval.

² Section 4.9, 12 U.S.C. 2160

Objective, Scope and Methodology

The objective of this audit was to assess whether FCA's approval process of Funding Corporation debt issuances on behalf of the FCS is operating efficiently and effectively and in compliance with applicable guidelines.

Our audit focused on discount notes and bond approval since they represent the largest dollars issued and outstanding by the FCS.

In performing this audit, we performed the following procedures:

- Identified and reviewed related laws, regulations, and Agency policies and procedures;
- Obtained background information on FCDS;
- Reviewed audits performed by the Government Accountability Office that are related to the subject matter;
- Conducted interviews of Primary Reviewing Analysts, Authorizing Officials, the Director of the Office of Regulatory Policy (ORP), the Director & Associate Director of the Office of Secondary Market Oversight, the Examiner in Charge for the Funding Corporation, and a Senior Attorney in the Office of General Counsel;
- Determined whether other GSEs that issue debt securities were required to have approval from their respective regulators;
- Reviewed documentation and databases supporting the Funding Corporation debt issuance approval process;
- Reviewed a sample of funding requests from the Funding Corporation covering 5 months during the period August 2010 through April 2011;
- Compared the actual approval process to policies and procedures;
- Identified significant internal control processes and determined if they were operating effectively and efficiently; and
- Determined the time elapsed from receipt of funding requests to final approval.

This audit was performed in accordance with generally accepted auditing standards for Federal audits at FCA headquarters in McLean, Virginia, from February through August 2011. At the conclusion of this audit, we provided management with a draft report of our observations.

Background on Farm Credit System Debt Securities

FCDS are primarily issued by the Funding Corporation in domestic and global capital markets. FCDS include System-wide debt obligations that consist of discount notes, designated bonds, fixed rate and floating rate bonds, and master notes in varying structures and maturities. The Funding Corporation issues, markets, and handles System-wide FCDS on behalf of FCS banks. System-wide FCDS are unsecured, joint and several obligations of the FCS banks and are not guaranteed by the United States Government. The charts below show the dollars of FCDS issued and outstanding from 2008 through 2010.

Debt Issued³

| (\$ billions) | as of 12/31/10 | 2009 | 2008 |
|---------------------|-------------------|--------------|--------------|
| Discount Notes | 415.6 | 407.2 | 407.9 |
| Designated Bonds | 3.4 | 8.5 | 10.0 |
| Fixed-Rate Bonds | 82.8 | 69.3 | 67.8 |
| Floating-Rate Bonds | 32.0 | 37.9 | 32.7 |
| Other | 0.1 | 0.2 | 0.5 |
| TOTAL | 533.9 | 523.1 | 518.9 |

Debt Outstanding⁴

| (\$ billions) | 12/31/10 | 12/31/09 | 12/31/08 |
|---------------------|--------------|--------------|--------------|
| Discount Notes | 19.2 | 11.6 | 16.2 |
| Designated Bonds | 28.6 | 31.3 | 30.5 |
| Fixed-Rate Bonds | 86.7 | 81.6 | 86.8 |
| Floating-Rate Bonds | 52.9 | 51.4 | 42.3 |
| Other | 0.1 | 0.2 | 0.5 |
| TOTAL | 187.5 | 176.1 | 176.3 |

In addition to setting the terms of each System-wide debt issuance, the Funding Corporation is required to determine the conditions for bank participation in System-wide debt obligations. The Funding Corporation and FCS banks voluntarily signed agreements called the Amended and Restated Market Access Agreement (MAA) and Restated Contractual Interbank Performance Agreement (CIPA). These agreements among the FCS banks establish and measure financial conditions for FCS banks to participate in System-wide obligations. The CIPA contains specific financial indicators to measure performance such as capital, asset quality, earnings, interest-rate risk, and liquidity. The CIPA also contains monetary penalties if a FCS bank fails to meet the performance standards.

³ Source: http://www.farmcredit-ffcb.com/farmcredit/programs/overview_debt_issued.jsp

⁴ Source: http://www.farmcredit-ffcb.com/farmcredit/programs/overview_debt_outstanding.jsp

If a FCS bank falls below the specified performance criteria identified in the agreements, it would become a Category I, II, or III bank. Banks categorized as I, II, and III have additional monitoring and reporting to the Funding Corporation. Banks categorized as II or III may be limited in their level of participation in System-wide debt issuances. If a FCS bank meets the criteria defined in the agreements, they are not categorized and not subject to additional monitoring and reporting. The MAA is currently in the process of revision. The CIPA was revised on March 1, 2009.

Comparing GSEs with Similar Purpose and Source of Funding

Some GSEs facilitate lending for certain sectors of the economy such as agriculture and home ownership. The GSEs we researched were established as Federally chartered, privately owned enterprises to serve the credit needs of a specified part of the national economy identified by Congress.

We researched four other GSEs that have a purpose similar to the FCS and obtain funding through agency debt markets:

1. The Federal Home Loan Bank System (FHLB) is a GSE that supports mortgage lending and related community investment.
2. The Federal National Mortgage Association (Fannie Mae) is a stockholder-owned, publicly-traded GSE whose mission is to provide liquidity, stability, and affordability to the housing markets. Fannie Mae has been in conservatorship since 2008.
3. The Federal Home Loan Mortgage Corporation (Freddie Mac) is a stockholder-owned, publicly-traded GSE that was also created to provide liquidity, stability, and affordability to the housing markets. Freddie Mac has also been in conservatorship since 2008.
4. The Federal Agricultural Mortgage Corporation (Farmer Mac), part of the FCS, is a stockholder-owned, publicly-traded GSE created to make long-term credit available to farmers, ranchers, rural homeowners, rural utility cooperatives, and communities by providing a secondary market for qualified loans.

The FCS is the only GSE currently not in conservatorship that is required to have its debt approved by its regulator. Debt issuance by FCS and Farmer Mac are not subject to U.S. Treasury approval.

We compared these GSEs to determine if they were required to have debt issuances approved by their regulator. We found the GSEs have varying degrees of oversight by other government agencies including the Securities and Exchange Commission and the U.S. Treasury. Farmer Mac, Fannie Mae, and Freddie Mac are publicly traded companies requiring Securities and Exchange Commission disclosures. Debt issuance by FHLB, Fannie Mae, and Freddie Mac are subject to U.S. Treasury approval.

The FHLB's consolidated obligations were issued by their former regulator, Federal Housing Finance Board (FHFB)⁵, prior to 2000. The FHFB published a final rule in June 2000 transferring authority for issuance of the consolidated obligations to the FHLB. FHLB's consolidated obligations are now issued by FHLB's Office of Finance.

⁵ FHFB was replaced by the Federal Housing Finance Agency (FHFA) by the Housing and Economic Recovery Act of 2008. FHFA is the regulator for Fannie Mae, Freddie Mac, and FHLB. FHFA is also the conservator for Fannie Mae and Freddie Mac.

As a result of review and comparison to other GSEs during this audit, we did not identify any justification for the Agency to seek relief from the statutory requirement to approve FCS debt issuances. Instead, this audit assured us that FCA's prior approval of debt issuances provides an additional level of oversight and requires minimal resources.

Laws and Regulations that Govern FCS Debt Obligations

The Farm Credit Act is the primary legislation that governs FCS debt obligations. Sections 4.2, 4.9 and 5.17 of the Farm Credit Act require FCA approval of Systemwide notes, bonds, debentures or other obligations issued by the FCS. The Funding Corporation has primary responsibility for obtaining funds for FCS lending operations including issuing, marketing, and handling obligations issued under section 4.2(b) through (d) of the Farm Credit Act.

FCA Regulation, Part 615, provides responsibilities for funding, issuance of bonds, notes, debentures, similar obligations, and global debt securities. As part of FCA's responsibility to promote safety and soundness of FCS institutions, the Agency imposed by regulation the following financial requirements on FCS banks:

- Minimum liquidity reserve requirement of 90 days;
- Minimum permanent capital ratio of 7%;
- Minimum total surplus ratio of 7%;
- Minimum core surplus ratio of 3.5%; and
- Minimum net collateral ratio of 103%.

FCA Funding Approval Delegations, Policies and Procedures

FCA established policies and procedures for the funding approval process. We determined that the policies and procedures identified reflect the current funding approval process and did not identify any significant differences. We did note that some of the policies and procedures were outdated and may need some technical amendments because they referred to offices that have changed names and contained other minor inconsistencies. However, on the whole, the documented policies and procedures remain valid.

Delegations

We reviewed delegations related to the funding approval process and did not identify any weaknesses. We determined the delegations were clearly defined and included controls requiring a qualified funding approval team that consists of an analyst and approving official as well as backup personnel.

In 1994, the FCA Board reaffirmed the Chairman of the Board and Chief Executive Officer's (CEO) authority to approve System funding requests and recognized the CEO's authority to delegate funding issuance approval authority.⁶

After receiving the delegation from the Board, the CEO delegated authority to the Director of the Office of Regulatory Policy to approve routine funding requests. This delegation contained the following provisions:

- The CEO delegated to the Director of ORP the authority to approve routine funding requests submitted by the Funding Corporation.
- The CEO has sole authority to disapprove funding requests.
- The Director of ORP does not have the authority to approve changes in ceiling limits or new funding programs requested by the System.
- The Director of ORP may further delegate funding approvals to a qualified ORP member or committee.

Policies and Procedures

On February 2, 1998, FCA issued an Agency administrative policy that outlined the policies and procedures for processing funding requests submitted by the Funding Corporation. The primary criteria for approval are sufficient collateral and an authorized purpose for funding. Due to the critical role in timing of debt issuances, FCA's policy is to respond to funding requests as quickly as possible, not to exceed 48 hours. The policy requires a quarterly report to the FCA Board addressing approval activity, System debt issuances, collateral positions, and other relevant matters. In addition, it requires consultation with

⁶ FCA Board Action No. NV-94-25

the Farm Credit System Insurance Corporation (FCSIC) prior to approving any funding request that does not meet minimum capital requirements.

ORP issued an office directive that further defines policies and procedures for processing funding requests submitted through the Funding Corporation. In addition, this directive contains the following elements:

- Delegation of funding approvals based on specific criteria;
- A funding team consisting of a minimum of three ORP staff members with the ability to analyze, recommend approval or disapproval of funding requests, and monitor key data; and
- Procedures for monitoring, reporting, and contingency plans.

In our review of policies and procedures, we identified a difference in the record retention policy for funding approval documentation. ORP's directive stated records would be maintained for 3 years, while ORP's Recordkeeping Systems policy stated records would be maintained for 5 years. However, we learned that the record retention period is currently pending approval to reflect a 7 year retention period. ORP should ensure that applicable policies and procedures reflect this revised record retention period once it is approved.

We reviewed position descriptions for key personnel involved in reviewing and approving funding requests. Some of the position descriptions did not reflect responsibilities associated with the funding approval process. As a result of our observation, the Director of ORP is in the process of updating those position descriptions.

The Agency kept the Funding Corporation informed of any changes in personnel related to the funding approval process. We observed several updates sent to the Funding Corporation that disclosed changes in FCA's authorized Reviewing Analysts and Approving Officials.

FCA's Approval Process for Funding Corporation Debt Issuances

FCA developed clearly defined criteria for funding approvals. Each bank's funding request is evaluated for the following elements:

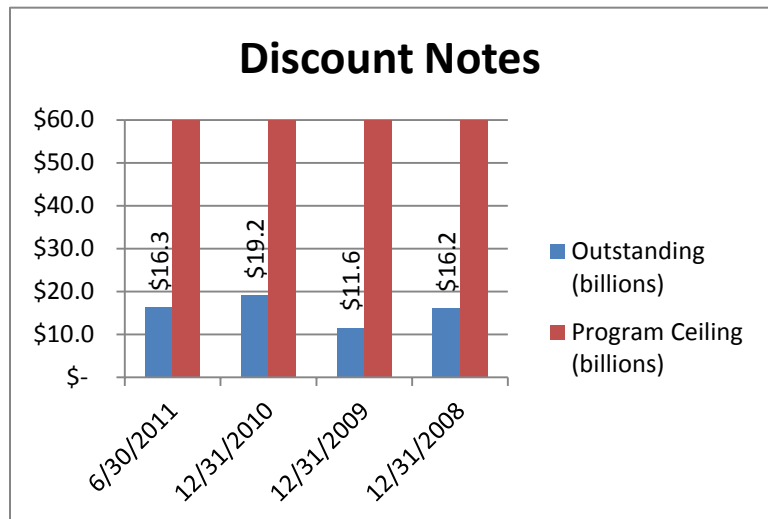
- Routine in Nature / Funding for Authorized Purposes
- Statutory Collateral Ratio
- Net Collateral Ratio
- Permanent Capital Ratio
- Total Surplus Ratio
- Core Surplus Ratio
- Financial Institution Rating System Composite Rating
- MAA and CIPA
- Days of Liquidity
- Minimum Capital Requirements
- Trends in Key Financial Data

FCA's approval process of funding requests varies by debt product:

- Discount Notes
- Unscheduled Bonds and Designated Bonds
- Retail Bonds and Other Small Programs

Discount Notes

Discount notes are generally issued daily with a maturity of less than a year and represent the largest amount of FCS debt issued during 2010. The approval process for discount notes is based on a program approval due to the short-term nature of this debt instrument. In its program approval, FCA imposed a blanket ceiling that limits the amount of outstanding discount notes. The current ceiling is \$60 billion. See the chart for a comparison of the discount notes ceiling to discount notes outstanding.



FCA’s CEO approved the Discount Notes Program with the requirement that a FCS bank must meet certain conditions. If the bank meets the following additional conditions, the Funding Corporation may issue discount notes on the bank’s behalf without any additional approval from FCA:

- Maturity less than 365 days;
- FCA may modify or revoke approval at any time; and
- FCA prior approval is required before issuing any discount notes on behalf of a System Bank in Category I, II, or III under the Market Access Agreement.

The Discount Notes Program has been revised several times over the past couple of decades. When the Funding Corporation determines the System needs an increase in the discount notes ceiling, it requests approval from FCA. The last increase was approved by FCA’s CEO for \$60 billion outstanding in discount notes on September 24, 2008. However, not all requests for increases to the discount notes ceiling have been approved by FCA. In 1990, FCA denied a request by the Funding Corporation to increase the discount notes ceiling because, “FCA has significant concerns about the System’s excessive liquidity levels, arbitraging activities, and illiquid and ineligible investments.”

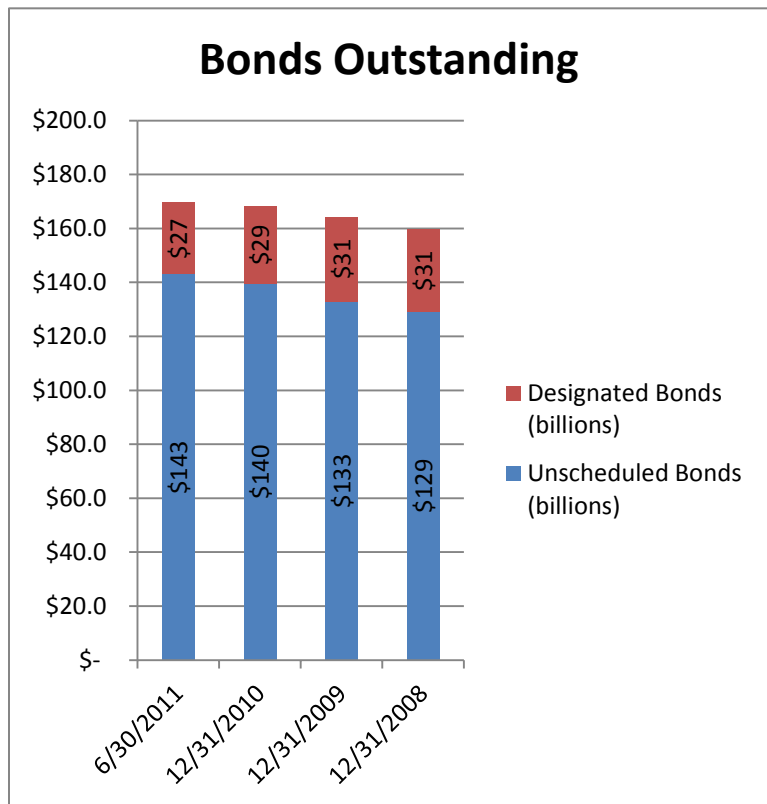
Unscheduled Bonds and Designated Bonds

Bonds generally have a maturity range from 1 year to 10 years.

- Unscheduled bonds are issued throughout the month.
- Designated bonds reflect larger issuances and are issued quarterly or as needed.

The approval process for unscheduled and designated bonds is done through a funding approval request. The Funding Corporation submits each System bank’s funding request on a monthly schedule that runs from the middle of one month to the middle of the following month. This request is based on each individual bank’s projection

of its unscheduled bonds issuance needs for that upcoming period given what it expects in terms of loan growth, maturing debt, and exercised calls. If the bank meets the Funding



Corporation's criteria, the Funding Corporation groups all of the banks' monthly funding requests and forwards to FCA for approval. The designated bonds funding requests are separate from and do not count toward the bank's monthly funding request but do have similar criteria to meet before being approved. The Funding Corporation has conservative criteria that a bank must meet before it will forward a bank's request to FCA. In addition, each bank, through the Funding Corporation, is required to provide FCA with monthly certification of key financial data which includes collateral and liquidity positions.

Each bank is authorized to participate in bonds issued by the Funding Corporation throughout the month up to the amount requested and approved by FCA on its respective monthly funding request. If a bank has unforeseen needs and anticipates it will exhaust its monthly approval, it can request an interim funding request to provide additional funding until the next monthly cycle.

When the monthly funding request is received by FCA, one of three ORP analysts processes the approval request. The analyst reviews each bank to ensure it meets or exceeds the predefined criteria (previously outlined on p. 11), reviews quarterly call report data, observes trends in key financial data, and documents the analysis. If the analyst determines the System bank has sufficient collateral, meets or exceeds capital ratios, and does not have any concerns related to the System bank or capital markets, the analyst recommends approval to an approving official. The analyst also determines if the FCSIC needs to be consulted and whether the approval is within the delegated authority of the Associate Director of ORP's Finance and Capital Markets Team. If a bank's monthly funding request is significantly larger than normal, the analyst contacts the Funding Corporation for additional information.

The approving official reviews the documentation provided by the analyst and provides approval, if appropriate. As a result of close monitoring by FCA and the Funding Corporation's conservative criteria, ORP is not aware of any monthly funding requests denied by FCA.

During the audit, we reviewed a sample of funding requests. The purpose of our review was to determine if the approval process was consistent with established laws, regulations, and policies and procedures. Specifically, we determined that funding requests:

- Were logged in the database;
- Were routine in nature and to be used for authorized activities;
- Met criteria for delegated approval by the Associate Director of ORP's Finance and Capital Markets Team;
- Had appropriate collateral and liquidity certifications; and
- Were signed by authorized reviewing analyst and approving official.

The results of our review indicated that the approval process for bonds was well documented and consistent with established laws, regulations, policies and procedures.

Approval was made within 3 hours of receipt of required documentation including approval request forms and certifications. Although minor issues were identified with data incorrectly logged in the ORP Funding Approval database for a couple of approval requests, these issues would not change the approval determination.

We also observed that the approval process requires duplicate keying of financial data. However, we are not making a recommendation to streamline this process since ORP is planning an information technology project in fiscal year 2013 that will “facilitate interactive processing of funding requests and improve communication across offices, including the prompt sharing of information with interested parties.”

Retail Bonds and Other Small Programs

FCA’s CEO approved the Farm Credit Retail Bond Program effective November 18, 2010. This new program represents a small percentage of FCS debt. Bonds issued under this program will be included in each respective bank’s monthly funding request.

In addition, there are other small programs that represent an immaterial amount of FCS debt that have been approved by FCA.

FCA's Monitoring and Reporting

ORP closely monitors financial trends impacting the FCS and agency debt markets. We reviewed various reports and briefing documents provided by ORP and determined they kept the FCA Board and senior management well informed of related market events through periodic reports and briefings.

ORP has frequent contact with FCA's Office of Examination (OE) and the Funding Corporation to discuss and monitor adverse events. Routine monitoring performed by ORP includes:

- The agency debt markets and System's ability to access the market;
- Trends in key aspects of banks' financial data;
- Periodically reviewing FCS website including debt issued;
- Reviewing debt issuance and discount note allocation reports; and
- Reviewing monthly reports and quarterly flash reports provided by OE.

As part of its monitoring strategy, ORP periodically meets onsite with Funding Corporation management to discuss the funding approval process, reporting expectations, current events impacting the GSE debt market, and other topics impacting the FCS.

During the financial crisis, ORP increased the frequency of collateral and liquidity reports from quarterly to monthly and increased monitoring of FCS' debt composition. ORP also performed stress testing to determine the amount of loan deterioration that would cause a bank to trigger a MAA Category I.

ORP provides periodic reports to the FCA Board and senior management including weekly email reports with FCS debt yield curves, issuance activity, and FCS basis points over Treasuries. In addition, ORP's monthly status reports include funding approval activity, liquidity, and funding management information. As significant events occur that impact FCS funding, ORP provides additional reporting. For example, in July 2009, ORP provided the Board and senior management with a briefing on the impacts of the CIPA and MAA on the FCS including results from stress tests performed on two System banks.

As part of FCA's safety and soundness examinations of the Funding Corporation and System banks, OE verifies data provided by the Funding Corporation and System banks and reconciles actual debt issuances with debt issuances approved by ORP. OE and ORP work closely together to monitor the financial health of System banks. Without ORP's involvement in the funding approval process, OE would likely require additional resources to perform additional monitoring and analysis that is currently performed by ORP.

Acronyms

| | |
|-------------|--|
| CEO | Chairman of the Board and Chief Executive Officer |
| CIPA | Restated Contractual Interbank Performance Agreement |
| FCA | Farm Credit Administration |
| FCDS | Farm Credit Debt Securities |
| FCS | Farm Credit System |
| FCSIC | Farm Credit System Insurance Corporation |
| FHFB | Federal Housing Finance Board |
| FHLB | Federal Home Loan Bank System |
| Fannie Mae | Federal National Mortgage Association |
| Farmer Mac | Federal Agricultural Mortgage Corporation |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| GSE | Government-Sponsored Enterprise |
| MAA | Amended and Restated Market Access Agreement |
| OE | Office of Examination |
| OIG | Office of Inspector General |
| ORP | Office of Regulatory Policy |

R E P O R T

Fraud | Waste | Abuse | Mismanagement



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