

Office of Inspector General

Farm Credit Administration's
Enforcement Program

I-06-01

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July 31, 2007



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The Honorable Nancy C. Pellett
Chairman of the Board and
Chief Executive Officer
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

Dear Chairman Pellett:

The Office of Inspector General completed an inspection of the Farm Credit Administration's Enforcement Program. The objective of the inspection was to assess the readiness of the Farm Credit Administration (FCA or Agency) to take an enforcement action.

The financial condition of the Farm Credit System has been healthy for many years; therefore, the FCA's use of its enforcement authority has not been necessary. Nevertheless, the Agency should be better prepared to exercise its enforcement authority should the need arise. Many personnel remain with the Agency with experience in enforcement matters from the 1980s and early 1990s, affording FCA a strong foundation from which to build its readiness. During this inspection, the Agency agreed with the Office of Inspector General's (OIG) findings and to the following actions:

- FCA staff positions likely to be involved in any enforcement action will be identified and their duties defined.
- Knowledge from employees experienced in enforcement matters will be captured.
- Enforcement policies, procedures, and processes will be updated to include action steps, timelines, and formats that will be used for various enforcement documents and reporting.
- Briefings on enforcement authorities, policies, procedures, and processes, including the avoidance of *ex parte* communication, will be developed and provided to all appropriate personnel.
- FCA Board policy guidance and thresholds will be developed to ensure decisions concerning the Agency's use of enforcement authority are brought to the attention of the FCA Board, or an intermediate decision-making body, when certain criteria are met.
- Measures will be developed to ensure adjudication advice is independent of involvement in the investigation or prosecution of any enforcement action.

We performed this inspection in accordance with the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency "Quality Standards for Inspections." We conducted fieldwork between August 2006 and March 2007. The OIG held an exit conference with management on June 14, 2007, and with you and your Executive Assistant on June 21, 2007. Based on those meetings, we provided a final draft report to you and management on June 27, 2007. Subsequently, your office and management presented planned actions to the OIG to address the report's recommendations. As a result, all recommendations have been changed to agreed-upon actions.

If you have any questions about this report, I would be pleased to meet with you at your convenience.

Respectfully,

A handwritten signature in cursive script that reads "Carl A. Clinefelter".

Carl A. Clinefelter
Inspector General

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BACKGROUND

Congress gave the Farm Credit Administration (FCA or Agency) enforcement authorities in 1985 in Title V, Part C of the Farm Credit Act of 1971, as amended (Farm Credit Act). These enforcement powers enable the FCA to impose rehabilitative or punitive enforcement measures on boards and management teams of Farm Credit System (FCS or System) institutions for violating a law, rule or regulation and/or engaging in an unsafe or unsound condition or practice. These powers include the authority to enter into formal agreements; issue orders to cease and desist; levy civil money penalties; and suspend, remove, or prohibit officers, directors, and any other persons from participating in the affairs of a FCS institution.

In addition to law and regulations, FCA Board Policy Statements 34 and 53 refer to the Board's oversight and statutory authority to impose enforcement actions. FCA Board Policy Statement 34 calls for the initiation and termination of enforcement actions to be disclosed to the public (without specific reference to any institution or person) unless there would be an adverse effect on criminal or civil litigation. FCA Board Policy 53 provides general philosophy and direction for the examination and oversight of the FCS. It states that heightened examination and oversight, including appropriate enforcement measures, will occur when institutions are unable or unwilling to address material unsafe or unsound practices or comply with law or regulations.

Soon after the Agency received enforcement authority, primary responsibility for the enforcement function was placed with the newly created Supervision Division (SD) of the Office of Analysis and Supervision (OAS), an office separate from the Office of Examination (OE). Although SD's and OAS's names changed during the decade following the initial set up, the enforcement function within this structure remained in place until 1997 when, with FCA Board approval, the Office of Policy Development and Risk Control (a successor office to OAS) transferred responsibility for the enforcement function to OE.

Prior to the transfer to OE, enforcement activity had significantly declined (88 actions in place in 1990; 5 actions in place in 1997). FCA has not imposed an enforcement action since 1997, as the credit and financial condition of the System, and the performance of FCS boards and management teams has substantially improved. Virtually all System institutions now have a Financial Institution Rating System (FIRS) rating of 1 or 2.

FCA oversight of the System has evolved over time due to both challenges and opportunities in the financial, agricultural and economic environments, and resultant changes in the System. OE has realigned resources, in part, to adjust to these changes and to move from traditional examination methodologies to a risk based model of oversight.

With respect to the Federal Agricultural Mortgage Corporation (Farmer Mac), Title VIII, Section 8.11, of the Farm Credit Act gives the FCA, acting through the Office of Secondary Market Oversight (OSMO), the same enforcement authorities the Agency has with respect to the rest of the FCS. For Farmer Mac, in addition to the usual considerations given to imposing an enforcement action, FCA is also required to consider

the purpose for which it was created, the practices appropriate to the conduct of secondary markets in agricultural loans, and the reduced levels of risk associated with appropriately structured secondary market transactions.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this inspection was to assess the readiness of the Agency to take an enforcement action.

The scope of the inspection work included the following:

1. Interviews with FCA Board (Board) Members and their Executive Assistants.
2. Interviews with the Chief Examiner and OE's Director, Risk Supervision Division (RSD).
3. Interviews with staff from the Office of General Counsel (OGC).
4. An interview with the Director of the OSMO.
5. A review of the statute and regulations pertaining to FCA enforcement authorities.
6. A review of the Examination Manual, and other OE policies and directives involving enforcement.
7. A review of documents related to recent instances of Agency oversight actions.

The inspection announcement was sent to the Chairman, Chief Examiner, and others on July 27, 2006. The entrance conference was held on August 16, 2006. Fieldwork was performed between August 2006 and March 2007. A discussion draft was issued on April 26, 2007, and exit conferences were held on June 14 and June 21 with management and the Chairman, respectively. A final draft report was issued on June 27, 2007. No comments were received.

This inspection was performed in accordance with the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency "Quality Standards for Inspections."

FINDINGS AND RECOMMENDATIONS

In recent years, enabled by the strong financial health of the System, OE's focus has been on the recognition and oversight of System risk, rather than enforcement. As a result, the enforcement program received less use and emphasis than in the late 1980s through the mid-1990s. While the System seems essentially free of the conditions that precipitated enforcement actions in the past, the Agency should be better prepared to exercise its enforcement authority should the need arise.

The Agency's ability to effectively and efficiently exercise its enforcement authority will be enhanced by:

- ensuring that enforcement policies, procedures, and processes are current;
- providing training to FCA staff likely to become involved in the enforcement process; and
- clarifying the FCA Board's role in the Agency's use of its enforcement authority.

Readiness and Training Should Be Improved

Readiness

Prior to 1997, when enforcement was transferred to OE, a key component in the enforcement process was the Regulatory Enforcement Committee (REC). The REC was an Agency committee with a defined membership. The chair was the director of the office responsible for enforcement. The other members were the General Counsel and the Chief Examiner. The REC would meet to decide whether a recommended enforcement action should move forward to the FCA Board for consideration. Although OE procedures and directives from the 1980s and 1990s refer to the REC, there have been infrequent meetings and its membership is not adequately defined. The Chair is specified in a 2005 OE publication but the other members are not. When interviewed, the Chief Examiner mentioned the other REC members were the General Counsel and the Director of the Office of Regulatory Policy. However, others interviewed were not aware of the current membership beyond the Chief Examiner and the General Counsel.

Additionally, other enforcement personnel in the Agency are not well defined. While there is a multitude of useful documentation reflecting practices and experiences from the years when enforcement was active, enforcement process flow charts, policies and procedures have not kept pace with organizational changes. The same is true of OGC's former Litigation and Enforcement Division (LED) directives. For example, the OE enforcement flow chart shows outdated titles such as Field Office Director, OE Special Supervision Committee, Enforcement Examiner and Director of SESD. The Chief Examiner, RSD Director, and OGC staff acknowledged enforcement policies, procedures and other internal guidance have not kept pace with the FCA organizational changes. Priorities have been placed elsewhere and minimal resources have been committed to updating enforcement guidance.

Today, RSD has enforcement as part of its duties. According to interviews conducted with OE management, the RSD Director would be expected to put the enforcement process in motion, if necessary. The RSD Director stated he would rely on processes developed in the past, and as appropriate, engage those who are experienced in preparing and serving enforcement documents and are still with the Agency. Updating designations and defining roles will enable enforcement personnel to understand their roles and when to take action, hence promoting readiness.

The Director of OSMO said that if Farmer Mac were considered for an enforcement action, the recommendation and approval process would be different than for other FCS institutions. Given the more streamlined reporting structure of OSMO, the enforcement process would be limited to the OE Examiner-in-Charge, OSMO's Associate Director for Examination and Supervision (AD/ES) and the Director of OSMO. He said that following consultation with OGC, the AD/ES would make a recommendation to the Director of OSMO who in turn would consult with OGC, draft enforcement documents, and make the recommendation to the FCA Board. Although this framework has been discussed within OSMO, the process and procedures are not in final form.

Agreed-Upon Actions

- 1. FCA staff positions in OE, OGC, Office of Regulatory Policy and OS MO, likely to be involved in any enforcement action, will be identified and their duties defined.**
- 2. OE will capture knowledge from employees experienced in enforcement matters.**
- 3. The FCA Board, OE, OS MO, and OGC enforcement policies, procedures, and processes will be updated to include action steps, timelines, and formats that will be used for various enforcement documents and reporting.**

Training

During interviews, it was clear that FCA Board Members and Agency staff, including OS MO, are aware of the significance of FCA's enforcement authorities and the part the authorities play in fortifying the Agency's role as an arms-length regulator. Those interviewed thought the need for an enforcement action in the near-term is not imminent and expressed confidence that, should the need arise, FCA staff could competently execute an enforcement action.

While an enforcement action may or may not be imminent, FCA Board Members indicated it was important for them to be better informed about enforcement authorities and for Agency personnel to be better prepared for events that may warrant an enforcement action. They also expressed an interest in attending joint briefings that would include information on the types of enforcement authorities available to the Agency, the processes involved in imposing an enforcement action, and a review of their roles in the enforcement process. Examples and explanations of concepts such as the criteria for considering an enforcement action; the composition and purpose of the REC; other internal controls to ensure objectivity in the Agency's use of enforcement authorities; the adjudication process, including hearing and review of an enforcement action; and the "firewall", a construction to avoid ex parte¹ communication during adjudication would be beneficial since none of the FCA Board Members has experienced an enforcement proceeding as a regulator or adjudicator.

Agreed-Upon Action

- 4. Briefings on enforcement authorities, policies, procedures, and processes, including the avoidance of ex parte communication, will be developed and delivered to FCA Board Members and FCA staff likely to become involved in an enforcement action.**

¹ Ex parte communication refers to improper unilateral contact with a court, arbitrator or represented party without notice to the other party. For example, an examiner, attorney, or other FCA employee or agent that performs investigative or prosecuting functions in a case shall not participate or advise in the decision of the presiding officer (ALJ) or the FCA Board, except as a witness or counsel in the proceeding, or as otherwise authorized by law. In other words, there must be some division between the roles of advising and prosecuting to ensure decisions are made based on the facts of a case.

FCA Board Involvement in the Enforcement Process

The Agency's use of its enforcement authorities requires the utmost care and has always rested within the sole purview of the FCA Board. It would be reasonable for institutions presented with an enforcement action to expect that the Agency's process for making decisions on enforcement be characterized by:

- An accurate determination of the factors causing the enforcement action, and
- A deliberate, thoughtful, objective enforcement consideration process within the Agency characterized by appropriate internal controls.

It would also be reasonable for the FCA Board to expect that all circumstances that may warrant Agency enforcement action are timely brought before it for consideration and that any recommended action is well justified.

Today, as in the past, most issues that give rise to considering an enforcement action are identified during the examination or monitoring of an institution. Examples of such issues would include an unsafe or unsound business practice or condition, a violation of a statute or regulation, or noncompliance with a final order to cease and desist. One or a combination of these factors may result in OE lowering the composite FIRS rating to "3" or worse.

From the late 1980s through the early 1990s, a period when the Agency was actively using its enforcement authorities, Agency policy provided that an institution with a composite FIRS (then called CAMEL) rating of "3" or worse would be referred by OE to the office with enforcement responsibility accompanied by a recommendation to take or not take enforcement action. If enforcement action was recommended, OE was to also recommend the type of action. Once the matter was referred by OE, a determination as to what type of enforcement action was appropriate and supportable would be made collaboratively by the office with enforcement responsibility and an OGC enforcement attorney. This was then presented to the REC by the enforcement examiner and enforcement attorney. With the REC's concurrence, a final recommended enforcement action was presented to the FCA Board for consideration.

The Associate General Counsel most knowledgeable and experienced in enforcement matters retired in January 2007. He came to the OGC in 1987 and worked extensively with the SD for several years in the development and delivery of enforcement actions. In 1991, he became head of the former LED. In his opinion, prior to 1997 there was more certainty and balance in the enforcement process, which provided "a broader perspective and less chance for bias." Whereas, he thought the current structure of the enforcement process was unclear.

Currently, OE makes the decision when to advance an issue to other components of the Agency for collaborative consideration as to what type, if any, enforcement action is warranted.

The FCA Board should identify thresholds that would dictate when the Agency would consider use of enforcement authority. Thresholds could be aligned with, for example,

the FIRS rating, the quantity and materiality of violations of statutes or regulations, the degree of unsafe or unsound practices or conditions, and/or the degree of unwillingness or inability of the institution to take corrective action, or other conditions that warrant referral.

It would also be prudent for the Agency to be fully prepared to engage in enforcement adjudication in compliance with the Administrative Procedure Act. Since 1997, OGC has changed organizationally. There was the former LED. The attorneys in this division were involved in preparing notices of charges and assisting enforcement examiners in making a recommendation to the REC and then to the FCA Board to place an institution under enforcement action. In addition, the LED provided a separation of duties aimed at avoiding any appearance of ex parte communications (as previously described). Another OGC division, the Corporate and Administrative Division, was assigned to provide assistance and advice to FCA Board Members concerning an enforcement adjudication. Today, the structure of the firewall is not distinct since there are no longer these two divisions.

Agreed-Upon Actions

- 5. The FCA Board will establish policy guidance and thresholds that ensure decisions concerning the Agency's use of enforcement authority are brought to the attention of the FCA Board, or an intermediate decision-making body, when certain criteria are met.***
- 6. The OGC will implement measures to ensure its capability to advise the FCA Board during adjudication, independent of involvement in the investigation or prosecution of any enforcement action.***

REPORT


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