

**Fourth Quarter (July 1 – September 30, 2012)
and Fiscal Year (FY) 2012 Summary Report**

**Office of Inspector General's (OIG) Survey of Farm Credit System (FCS) Institutions
Regarding the Agency's Examination Function**

Introduction

Based on the interface FCS institutions had with the Agency's examination function during the period July 1 – September 30, 2012, the Office of Examination (OE) identified 25 FCS institutions that were in a position to provide meaningful survey responses.

The OIG sent surveys to those 25 institutions on October 16. Of the 25 institutions surveyed, 23 submitted completed surveys. If a nonresponding institution subsequently sends a completed survey, it will be included in the next quarterly report.

One response to the survey issued for the third quarter of FY 2012 was received subsequent to the third quarter report being issued and is included in this report. Therefore, this report includes responses from a total of 24 institutions.

The OIG will continue to provide an email report to you based on each FY quarter-end, i.e., December 31, March 31, June 30, and September 30, so that you may timely take whatever action you deem necessary to address the responses. The fourth quarter report as of September 30 will continue to include FY summary data.

The survey asks respondents to rate the eight survey statements from "1" (Completely Agree) to "5" (Completely Disagree). The rating options are as follows:

| | |
|----------------------------|---|
| Completely Agree | 1 |
| Agree | 2 |
| Neither Agree nor Disagree | 3 |
| Disagree | 4 |
| Completely Disagree | 5 |

There is also an available response of "6" (Does Not Apply) for each survey statement.

Narrative responses are provided verbatim, except that any identifying information has been removed and any grammatical or punctuation errors may have been corrected. Any narrative in "brackets" is explanatory information provided by the OIG based on conversations with institution management.

Survey Results – Fourth Quarter FY 2012

Average numerical responses to survey statements 1-8 ranged from 1.8 to 2.1.

| Average Numerical Responses to Survey Statements 1 – 8 | | | |
|--|-------------------------|-------------------------|-------------------------|
| 4 th Quarter | 3 rd Quarter | 2 nd Quarter | 1 st Quarter |
| 1.8 – 2.1 | 1.6 – 2.4 | 1.7 – 2.1 | 1.7 – 2.1 |

The average response for all survey statements was 1.9.

| Average Response for all Survey Statements | | | |
|--|-------------------------|-------------------------|-------------------------|
| 4 th Quarter | 3 rd Quarter | 2 nd Quarter | 1 st Quarter |
| 1.9 | 2.1 | 1.9 | 2.0 |

In this quarter, there were many more **positive** than negative narrative comments to survey statements 1-8. (Negative comments of any degree are color coded in red.)

Survey item 9 asks for feedback on the most beneficial aspect of the examination process. Consistent with prior quarters' responses to this survey item, many very positive comments were provided about the examiners and the examination process.

Survey item 10 asks for feedback on the least beneficial aspect of the examination process. While most were negative, as would be expected, several comments provide a perspective that should prove constructive. The first bullet under this survey item may be of particular interest.

Survey item 11 asks for any additional comments from the Board as a whole. This is a new survey item beginning with this fiscal year inserted at the request of OE. It elicited a number of thoughtful responses from Boards, which was the objective of the question. This quarter, most of the Boards' comments were **positive**. However, the first two bullets under this survey item are of interest, particularly the second.

Survey Results – FY 2012 Summary

For FY 2012, the OIG issued 65 surveys and received 58 completed surveys. There are two surveys from one institution included in this report, due to both the CEO and Audit Committee Chair responding. An FY 2012 Summary Report is on page 12.

Responses to Survey Statements 1–8

Examination Process

Survey Statement 1: The scope of examination activities was focused on areas of risk to the institution and appropriate for the size, complexity, and risk profile of the institution.

Average Response: 1.8 (3rd and 2nd Quarters were 2.1, 1st Quarter was 1.9)

Comments:

- The scope of the examination focused on areas of risk **but outcomes did not seem to be appropriate for the size, complexity or risk profile of this institution.**
- Exam team focused on high risk areas, had strong technical knowledge and broad knowledge of the FCS.
- Our institution has a high concentration in grain operations and the institution territory was subjected to a severe drought. The institution portfolio credit quality is also very high and there were mitigating factors for

the impact of the drought. The examiners took all the information into account as they focused on area of risk for the institution.

- Credit review appropriately focused on shared assets which we have sold to the System and other exposures that are consistent with size, complexity and risk profile. **Operational exams were mostly conducted with risk and complexity in mind, although sometimes exams may have been premature due to implementation process of new programs (i.e., social media).**
- Exam focused on higher risk areas.
- Overall scope was adequate in assessing institution's risk based on size and complexity.

Survey Statement 2: Examiners appropriately applied laws, regulations, and other regulatory criteria to examination findings and conclusions.

Average Response: 2.0 (3rd Quarter was 1.9, 2nd and 1st Quarters were 1.8)

Comments:

- Laws and regulations were appropriately applied during exam activities **but some other regulatory criteria appeared to be more appropriate for a larger institution.**
- The Internal Audit quality assessment was not necessarily a regulatory requirement but certainly represents an industry best practice.
- Exam team effectively tied exam work to relevant laws and regs.
- The examination team is well informed with respect to laws, regulations, and regulatory criteria. That knowledge was used appropriately during the examination and when findings and recommendations were discussed.
- Examiners followed exam guidance and other criteria in almost all examination findings and conclusions. We did experience limited examples of examiners applying guidance on a risk rating scale that is system developed rather than using the UCS classification prescribed by FCA.
- Exam team applied these appropriately.
- **However, application of Standard of Conduct regulation appeared to be inconsistent with the regulation as to inside or outside SOC officer. We also had differences as to global underwriting procedures on multiply entity borrowers.**
- In most cases the examiners referenced the appropriate regulation or law in evaluating a policy, procedure, or process.

Survey Statement 3: The recommendations, required actions, and any supervisory agreement with FCA assisted the board and management in addressing the risks of the institution.

Average Response: 2.0 (3rd Quarter was 2.4, 2nd Quarter was 2.0, 1st Quarter was 2.1)

Comments:

- Some recommendations will provide board and management the means to better evaluate the areas of risk in the institution.

- While the recommended and required actions addressed issues in the current FCA focus areas, they did not necessarily assist the board or management in addressing the risks of the institution.
- Exam team's observations were valuable in highlighting operating and strategic risks for management and the board.
- The institution management and board appreciate the third party external evaluation of risks facing the institution and the quality of operations provided by the FCA examiners.
- Recommendations were useful and implemented.
- We agreed with all recommendations. There were no required actions or supervisory requirements.
- One required action during the exam was to adjust quarter end numbers after the end of the quarter to be reflective of recommended loan downgrades. While we agree it is our responsibility to get them right and understand the need to disclose accurately, the agency should consider timing of onsite visits and materiality to the significant disruption to the roll up of district financial statements this creates.
- The recommendations were appropriate and fair.

Survey Statement 4: The examiners were professional and efficiently conducted examination activities.

Average Response: 1.8 (3rd Quarter was 1.6, 2nd and 1st Quarters were 1.7)

Comments:

- Examiners were professional and conducted activities with relative efficiency considering the youth of the team.
- The process was fairly efficient but the Internal Examiner asked the same question multiple times.
- Exam team was always very professional and interacted well with all levels of the organization.
- While the amount of time examining the institution has grown significantly, examiners were considerate and appeared to be efficient.
- We found the examiners to be well trained, knowledgeable and used our time appropriately.
- A very professional and experienced team.
- All examiners were professional. Prior coordination of any offsite examiners and their needs could be improved.
- All examiners were professional in their review techniques and allowed adequate time for discussing an issue or concern.

Communications

Survey Statement 5: Communications between the Office of Examination staff and the institution were clear, accurate, and timely.

Average Response: 2.0 (3rd and 2nd Quarters were 1.9, 1st Quarter was 1.7)

Comments:

- For the most part, communications were timely and accurate **but there were some instances where the spirit of the message was not clear or appropriately expressed.**
- **It appeared on occasion information provided was not received or misplaced by the EIC.**
- Clear and timely reporting and other communications. Lead examiner keeps in close touch throughout the year.
- In addition, the communications were well coordinated between management, board audit committee, and our internal review staff. Very much appreciated.
- The amount, clarity, and timeliness of communication between the OIC and our Board and executive management have improved significantly with our new EIC.
- The pleasant and inviting atmosphere the exam staff exhibited promoted open and helpful communication.
- Probably the best communications we have had in our experience.
- They appeared very rushed while on site. Might consider sending out all questions prior to being on site and we will have the answers for you.
- All examiners were professional. Prior coordination of any offsite examiners and their needs could be improved.
- There were no concerns expressed on the communication between staff and the exam team.

Survey Statement 6: Examination communications included the appropriate amount and type of information to help the board and audit committee fulfill their oversight responsibilities.

Average Response: 1.9 (3rd Quarter was 2.3, 2nd Quarter was 1.8, 1st Quarter was 1.7)

Comments:

- While overall communication was positive and productive, **the discussion with the CEO and the board on the overall FIRS ratings for the institution provided little insight as to how effectively the institution is being managed. In fact, the discussion seemed to reveal that the scores in Asset Quality and Capital served as a proxy for the overall Management score.**
- Examination report was clear and had the appropriate level of detail for the board and audit committee.
- The discussion concerning risks facing the institution as well as examination findings were very well articulated and understandable. Degree of risk and

level of concern was openly discussed to the satisfaction of board, management, and the exam staff.

- We value the oversight of our regulator, but it does not add value without candor and trust. Again, this is an area where we have experienced improvement under the new EIC, including greater meaningful communications.
- We found the instructions were well designed and useful in our applications of them.
- Team was very helpful to management, board, and Audit Committee.
- **Delivery of any exit report prior to the exit interview/call should be delivered in sufficient time to allow directors and staff to properly prepare for the meeting.**
- Required and recommended actions were appropriate and clear.

Survey Statement 7: Examiners fairly considered the views and responses of the board and management in formulating conclusions and recommendations.

Average Response: 1.9 (3rd Quarter was 2.1, 2nd Quarter was 1.9, 1st Quarter was 1.8)

Comments:

- The examiners did a good job listening and considering the responses of management. **Because of the youth of the team, there were cases when the response of management was interpreted later and not during the conversation.**
- Exam team has always considered management's views when drafting the examination report.
- Appreciated their interaction, on site and off.
- The discussions are always open, candid, and informative.
- **There was no opportunity for Board views and responses before the conclusions and recommendations were formulated.**
- Agree.
- We believe the examination staff listened to our concerns.
- Good dialog and discussions.
- We were pleased that examination team did spend sufficient time and energies on loan review discussions. **We would like to see that expanded to be inclusive of other areas examined as well.**
- The examiners allowed adequate time for challenges and discussion on issues. Management's views were considered in the final determination of a concern.

Survey Statement 8: FCS-wide guidance from the Office of Examination was proactive and helpful.

Average Response: 2.1 (3rd Quarter was 2.3, 2nd Quarter was 1.9, 1st Quarter was 2.0)

Comments:

- Sometimes more than we need.
- The guidance that is provided annually on the scope and focus areas for the coming years proves very useful to the institution.
- Timely and relevant updates.
- Appreciate the Office annually sharing Focus Areas.
- The majority of the reviewers have no real world experience making loans, nor operating an institution, thus they have limited credibility in assisting any one institution with recommendations for improvement. They know policies and that's about it.
- The system oversight initiatives are always fully explained; however, it is difficult to relate some of those activities to our local operations.
- We are concerned that the integrity and effectiveness of the regulation process may be circumvented with the increased use of bookletters and informational memorandums.
- The examiners provide sound direction on regulatory guidelines as well as opinions on best practices.

General Questions 9, 10, and 11

Survey Item 9: What aspect of the examination process did you find **most** beneficial?

- Best practice conversations, ideas and insight the exam team observed in other Farm Credit institutions.
- They were not intrusive to our normal course of business.
- Examiners were willing to listen to the institution's point of view. Examiners bring perspective from what they saw in other institutions.
- Examination discussions focused on "Best Practices" was very useful.
- Strong IT background of examiners allows for valuable feedback on technical initiatives.
- Open dialogue with examination staff.
- Just good communication.
- Risk Identification and Credit Administration.
- If I have to wait on FCA to tell me and the Board the condition of our organization, the Board needs to replace the management team. So there is limited benefit of the examination process.
- Sharing best practices.
- This institution's management and board always appreciate the FCA examination. This examination is one of the best mitigators of risk to the institution. Examiners are knowledgeable, thorough, and fair in their evaluation of the institution. We find the examination process to be value added.

- The in-person meeting with the Board helped provide context for the written report.
- Interaction with examiners when they have insight as to where the agency is coming from with requests and where they are taking it—though all this info is limited at an examiner level.
- Sharing of best practices.
- The regular communication with our EIC concerning FCA focus areas and how they relate to institution's operations.
- Dialogue with the examiner.
- Several helpful suggestions were made to improve our operations by our Lead Examiner.
- Face-to-face meetings with EIC during exam.
- The insight and guidance that our EIC brings to the table.
- Open dialogue with examiners.
- Examiners' attitude appeared to be more constructive/helpful than experienced in previous exams. Both the loan exit conference with Board Chairpersons and the final exit exam presentation were very helpful and professional.
- The closeout was very helpful in providing direction on concern areas.

Survey Item 10: What aspect of the examination process did you find **least** beneficial?

- Two ACAs merged in 2012. In September we had a visit from FCA to deliver the latest review of the merging ACA. The merging ACA was under FCA supervision. We were told by FCA that we would score all 2's in the FIRS ratings even though the ratios and numbers did not support 2's in all categories. Many were 1's. When questioned about it the FCA representative stated it was a subjective score and not objective. I know for a fact that all other institutions are scored by the scoring system developed by FCA and our ACA, the acquiring ACA, was scored on that system prior to merger. If FCA is going to have a scoring system then that system should be good for each and every institution. It appeared that the FCA representative was biased toward the institution and the CEO. The FCA representative stated that with any merger that this was the position of FCA and I beg to differ because this is not factual. The FCA representative stated that once trends were established that the scores then would be objectively used. This again is in question and does not appear to be the consistent behavior of this representative. The acquiring ACA consistently had one of the highest CIPA scores in the District and Management always scored a 2 which is not consistent with the comments of the FCA representative. We want to be measured as all other institutions are measured and take offense that we are not.
- Non-critical, technical/policy/procedure recommendations that could easily be resolved in the normal course of business without being formalized in the final report.
- The discussion on how the institution intends to utilize its capital to help support the struggling dairy industry seemed confusing when compared to the discussion relating to the FIRS rating areas of Capital and Asset Quality.
- Recommendations re: board policies may be more appropriate to the establishment of operating procedures.
- Nothing to report. Very professional.

- FCA's directive regarding changes to the distressed loan notice was unclear and that the institution just learned about it in October of 2011 through a training conference that one of the institution's loan officers attended and at a RAW conference. Thereafter, the institution attempted to contact an FCA Attorney for clarification, but never received a response. Therefore, the distressed loan notice was not changed until February of 2012.
- The application of Informational Memorandums and bookletters as well as interpretation of regulations, particularly new regulations, could be better coordinated between FCA and the examination staff. Perhaps this is simply timing issues and could be more noticeable during periods when many communications and regulations are being issued.
- Minor requirements and requests that are NOT risk based, but just new direction someone wanted to go without regard to risk.
- Some exams are one size fits all and not reflective of the size, risk, complexity or internal control environment in the institution. When this occurs, it feels more like a checklist review rather than evaluating safety and soundness.
- The Institution's condition has been improving over the past couple of years and we contribute some of that progress to the FCA examinations.
- Reporting redundancy that creates inefficiency.
- Struggled with scheduled dates as we were trying to have a Board Meeting and our Stockholders Meeting at the same time they were on site. Ask that we avoid this in the future.
- FIRS rating.
- End of quarter adjustments. Lack of clarity and consistence with SOC regulation.

Survey Item 11: Please provide any comments from the **Board as a whole** regarding the examination process not provided in the preceding responses.

- The board is extremely disappointed in the FIRS rating system. Particularly as it relates to our institution. In every objective area our institution is a one rating and yet management is rated 2. This seems to be a completely arbitrary rating and not appropriate.
- At the FCS Management Exit Conference [attended by our Chairman, FCA reported on their review of the quality of borrower financial information stating that this is a system-wide Agency focus which is not unique to our institution. FCA stated that the quality of financial statements from borrowers should be raised to a higher standard as the loan examination identified several credits where financial statements did not meet management's minimum requirements; i.e. audited financial statements. FCA noted that in all cases, waivers to lending guidelines were approved per institution policy and procedures; however, some large loan complexes were approved as exceptions after release of the March 29, 2011 FCA Informational Memorandum. FCA stated that as discussed in the Memorandum, higher quality financial statements become critical for large commercial operations. FCA noted weaknesses in the internal reporting of large and complex operations can undermine the reliability of internally prepared statements as shown in one of our accounts. FCA stated that the Agency expects higher quality statements from complex loans. FCA stated that we need to enforce

existing procedures regarding quality of financial information and raise our expectations to the Informational Memorandum standard. Our CCO responded stating that although Management appreciates FCA's stance, we take exception with the statement that our procedures do not address the Informational Memorandum, because they do adequately address the quality of financial information required as approved by our Board. Our CCO stated that we need to make business decisions based on the quality of the customers and competition in our marketplace while maintaining credit quality and operating in a safe and sound manner. FCA responded that per the Loan Underwriting Standards, if you do not meet the standard then that is an exception. FCA sees a high level of waivers/approvals that vary from the Standard and these will continue to be scrutinized as they can lead to severe credit quality issues with "super big large complexes". FCA noted that our institution processes and controls have improved, but overall FCA requires that this standard be met throughout the System. Our CEO interjected that one complex loan is a risk rated 4 credit, has operated for decades and is multifaceted and very strong financially; he asked if FCA had disagreed with our classification of the loan based on their exam guidelines. FCA stated that they did not lower any of the loans that were identified as exceptions in the exam. Our CEO followed up stating that our institution has quality customers and is following the policies approved by the Board of Directors and management stands behind the Board and their approved policies. Our institution will continue to follow these policies to insure that the institution maintains outstanding quality, but, as per the Board's direction, will also continue to make sound business judgments on a case by case basis, which at times may require policy waivers. Our CEO concluded that current credit quality of 99%, and the trend of outstanding credit quality during his 14 year tenure, justifies our institution taking measured risks and exercising judgment. FCA acknowledged our track record but commented that there will be friction on this matter as FCA's position comes from other institutions that have had loans that started with a 4 risk rating and dropped to 11 and then liquidated within a year. [Our insert: When a #4 drops to a 11 and is then liquidated within a year, the original loan classification by the institution was wrong, and every Agency that evaluated and reviewed the loan was not doing their job and or there was fraud involved. If an institution had multiple loans that follow this trend [which would seem doubtful], the System, from FCA down should initiate the necessary changes to end the trend]. FCA stated that their position relative to the quality of borrower financial information is a system-wide Agency focus which is not unique to our institution. FCA reiterated that the quality of financial statements from borrowers should be raised to a higher standard.

- The results of the exam were professionally delivered.
- We appreciated the communication, candor, etc.
- The Board and management believe the benefits derived from the examination process is not cost effective for the dollars we spend each year for it.
- We believe the examination provides real value to our organization. The examiners are knowledgeable and fully explain the scope of their examination as well as any findings or recommendations. We appreciate the time the exam staff take to explain and put into perspective their evaluation of our institution. We appreciate the open communication and candid discussion that we have

with the exam team during the presentation to the board and the executive session with the examiners.

- Would like to resume past practice of a close-out with one or more directors prior to final recommendations.
- A concern is the lack of FCA having limited to no dialogue with the other regulators on the Shared National Credit classifications. We believe that they may be able to influence SNC decisions with their agriculture understanding. Also, when we review to determine if we should classify similar to SNC, we believe they should have had some conversation with SNC to understand the rationale and share with us such rationale.
- Conversations in the Board room reflect an overall level of satisfaction with the FCA and its examination team. Because we have been operating in unfamiliar territory the FCA has helped us make some critical decisions.
- Concern that the agency delves way past arms-length safety and soundness.
- Follow up conference call with senior staff, Board Chairman and Audit Committee Chairman was very beneficial.
- The entire Board appreciated the honest and open communication style.
- Board had none other than the answers already noted.
- Collectively, the Board expressed a great deal of confidence and respect for the examination team and complemented them for soliciting feedback and engaging in face-to-face discussions with the Board, which proved to be extremely conducive to the exchange of differing views and opinions and resulted in robust and productive discussions on key topics. The Board, however, did express a need for improvement in the CAMELS/FIRS rating process and the recognition of our institution as a unique entity, without a broad set of peers for evaluation with similar relationships to capital, interest rate risk and liquidity measures. Some Board members felt that a more granular approach to the rating process would be useful in that it would provide a more precise level of achievement and identify trends of improvement or deterioration from one exam period to the next. Others believed a more useful set of standards and measures could potentially be developed to improve the value of the institutional rating.
- Final report was more timely delivered than in the past. Significant improvement in loan review exit discussion. Attitude of entire audit team improved.

FY 2012 Summary Report

Numeric Responses to Survey Statements 1-8

| Question | PERCENTAGE OF TOTAL RESPONSES | | | | | | | | | | | | Total No. Responses | Average Response |
|------------------------|-------------------------------|-------|------------|-------|--------------------------------|-------|--------------|------|-------------------------|-------|----------------------|------|---------------------|------------------|
| | Completely Agree (1) | | Agree (2) | | Neither Agree nor Disagree (3) | | Disagree (4) | | Completely Disagree (5) | | Does Not Apply * (6) | | | |
| 1 | 9 | 15.8% | 44 | 75.4% | 4 | 7.0% | 1 | 1.8% | 0 | 0.00% | 0 | 0.0% | 58 | 1.9 |
| 2 | 13 | 22.8% | 38 | 64.9% | 6 | 10.5% | 1 | 1.8% | 0 | 0.00% | 0 | 0.0% | 58 | 1.9 |
| 3 | 10 | 17.5% | 33 | 56.1% | 8 | 14.0% | 4 | 7.0% | 0 | 0.00% | 3 | 5.3% | 58 | 1.8 |
| 4 | 22 | 38.6% | 33 | 56.1% | 2 | 3.5% | 0 | 0.0% | 1 | 1.75% | 0 | 0.0% | 58 | 1.9 |
| 5 | 18 | 31.6% | 31 | 52.6% | 7 | 12.3% | 2 | 3.5% | 0 | 0.00% | 0 | 0.0% | 58 | 1.8 |
| 6 | 13 | 22.8% | 39 | 66.7% | 3 | 5.3% | 3 | 5.3% | 0 | 0.00% | 0 | 0.0% | 58 | 1.8 |
| 7 | 15 | 26.3% | 35 | 59.6% | 6 | 10.5% | 2 | 3.5% | 0 | 0.00% | 0 | 0.0% | 58 | 1.9 |
| 8 | 8 | 14.0% | 39 | 66.7% | 8 | 14.0% | 1 | 1.8% | 1 | 1.75% | 1 | 1.8% | 58 | 1.9 |
| Total Responses | 108 | | 292 | | 44 | | 14 | | 2 | | 4 | | | 1.9 |

* "Does Not Apply" not calculated in percentages.