



Farm Credit Administration

The Director's Role

A Guide to Leading Your
Institution Effectively

for the Directors of Farm Credit System Institutions





Contents

Preface	3
Introduction: The Farm Credit System, FCA, and FCSIC	5
The Farm Credit System	5
The Farm Credit Administration	6
The Farm Credit System Insurance Corporation	9
A System institution’s board of directors: Its structure and composition	13
Diversity and inclusion	13
Outside directors and other appointed directors	13
Financial experts	14
Board committees	14
A System institution’s board of directors: Its responsibilities and roles	19
Ensuring mission achievement	20
Providing business planning and strategic direction	21
Making policy	23
Providing oversight	25
Setting internal controls	31
Governing IT activities	32
Setting compensation	32
Standards of conduct for directors	35
Conflicts of interest	36
FCA’s examination, supervision, and enforcement authorities and activities	39
Examination	39
Supervision and enforcement	43
Conclusion: Some guiding principles	45
Appendix A: Financial condition and key financial ratios	49
Capital	50
Earnings	53
Liquidity	55
Sensitivity to interest rate risk	57
Appendix B: FCA Supervision and Enforcement Authority	61
Conditions imposed in writing	63
Written agreements	63
Directives	63
Cease and desist orders	63
Civil money penalties	64
Removals, suspensions, and prohibitions	64
Conservatorship/receivership	65



Preface

Throughout this document, “we” refers to the Farm Credit Administration, and “you” refers to a director on a Farm Credit System (FCS or System) bank or association board. Although the guidance was developed primarily for the directors of the boards of FCS banks and associations, much of it also applies to directors of the Federal Agricultural Mortgage Corporation (Farmer Mac) and the service organizations of the FCS.

To be elected or appointed to the board of a System institution is an honor. It is an expression of stockholder or board confidence in your ability to oversee the institution’s safe and sound operation for the benefit of its member-borrowers. However, that honor carries numerous responsibilities.

We have published this booklet to provide you with guidance and information related to your duties, responsibilities, relationships, and liabilities as a director of an FCS institution. However, this booklet does not address all issues that may arise during your tenure as a director, and it is no substitute for legal counsel. You should seek counsel from an attorney or another qualified advisor to address specific circumstances.

The Director’s Role has been revised and updated several times over the years. The current edition was published in spring 2021. If you have any questions regarding the content of this booklet, please contact us at the following address:

Office of Congressional and Public Affairs
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090
Telephone: 703-883-4056
Facsimile: 703-790-3260
Email: info-line@fca.gov

Additional information about FCA and the System is available on our website at www.fca.gov.



Introduction: The Farm Credit System, FCA, and FCSIC

Your bank or association is part of a nationwide network of financial institutions known as the Farm Credit System (FCS or System). Each chartered institution is a federal instrumentality. The System is regulated by the Farm Credit Administration (FCA) and has its debt obligations insured by the Farm Credit System Insurance Corporation (FCSIC).

System institutions are responsible for carrying out the mandates of the Farm Credit Act of 1971, as amended (Farm Credit Act). This act provides for a farmer-owned cooperative credit system that extends credit and related services to farmers, ranchers, producers or harvesters of aquatic products, and other eligible borrowers.

The Farm Credit System

In 1916, Congress created the System to operate under a cooperative structure and gave it a public mission of providing long-term and affordable credit services to agriculture and rural America.

A cooperative structure allows the System's farmer-borrowers to own and control the System. This important feature sets the System apart from most other commercial lenders.

The System is guided by the following seven cooperative principles shared by other co-ops around the world. The roots of these principles can be traced back to Rochdale, England, where the first modern cooperative was founded in 1844.

- **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.
- **Democratic member control.** Cooperatives are democratic organizations controlled by their members. Because each member has only one vote — regardless of the amount of stock owned or business conducted with the cooperative — members participate equally in setting policies and making decisions.
- **Members' economic participation.** Members contribute to, and democratically control, the capital of the cooperative. This arrangement benefits members according to the amount of business they conduct with the cooperative rather than the amount of money they invest in it.

- **Autonomy and independence.** Cooperatives are autonomous, self-help organizations controlled by their members. When 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.
- **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.
- **Cooperation among cooperatives.** Cooperatives serve their members most effectively by working together through local, regional, national, and international structures.
- **Concern for community.** While focusing on member needs, cooperatives work for the sustainable development of communities through policies and programs accepted by the members.

In 2010, the FCA board issued a policy statement (FCA-PS-80) reaffirming its support for, and commitment to, the core cooperative principles of member-ownership, member-control, and member-benefit as part of the cooperative business model of the System and the fulfillment of its public policy mission. You can read this policy statement on our website at www.fca.gov.

As a director of a System institution, you should understand the distinctive cooperative principles and philosophies your institution follows, and you should be aware of the implications of these principles and philosophies.

The Farm Credit Administration

The Farm Credit Administration is an independent federal agency under the executive branch of the U.S. government. FCA is responsible for ensuring that System institutions and Farmer Mac are safe, sound, and dependable sources of credit and related services for all creditworthy and eligible persons in agriculture and rural America. We fulfill this mission in two primary ways:

- Developing policies and regulations to help ensure the safety and soundness of System institutions
- Examining institutions to ensure that they operate in a safe and sound manner and comply with applicable laws and regulations

In addition, we offer guidance and resources to help System institutions fulfill their mission.

FCA is governed by a three-member board appointed by the president of the United States with the advice and consent of the Senate. Our headquarters are in McLean, Virginia. We also have field offices in Bloomington, Minnesota; Dallas, Texas; Denver, Colorado; and Sacramento, California.

FCA regulations

FCA's goal is to provide a regulatory environment that helps the System to safely and soundly offer high-quality, reasonably priced credit and related services. The regulations we issue have the full force and effect of law.

As a director, you will need to be familiar both with the laws that apply to the System and with FCA regulations. You can read the full text of the Farm Credit Act and other laws that apply to the System on our website at www.fca.gov.

Periodically we propose changes to our regulations and publish the pending actions on our website. Most regulatory actions are open to public comment for a prescribed time. As a director of a System institution, you may wish to comment on a proposed action. You may do so from the FCA website. We welcome and encourage your input.

How will you know when we've taken a regulatory action? We publish notices of all FCA regulatory actions in the Federal Register, which is the official daily publication for rules, proposed rules, and notices of federal agencies and organizations, as well as for executive orders and other presidential documents.

We also announce any regulatory actions we plan to take in news releases we issue following the monthly meetings of the FCA board. We email these news releases to the board chairs and managers of each System institution and post them on our website at www.fca.gov. For some proposed regulatory actions, we also issue fact sheets along with the news releases and post them on our website.

We publish agendas and dates for board meetings a week in advance in the Federal Register and on our website. To be notified when we post meeting announcements, news releases, and other content to our website, go to www.fca.gov and subscribe for news and updates from FCA.

Guidance provided by FCA

In addition to regulations, FCA also issues guidance to System institutions in the following forms:

- **Policy statements.** Board policy statements express the broad policy goals and positions of the FCA board and are published in the Federal Register.
- **Bookletters.** Bookletters communicate enhanced interpretations of our regulations as well as our policy positions on specific issues.
- **Informational memorandums.** These communications discuss current issues facing the System or provide instructions for required reports.
- **Frequently asked questions.** Our website features FAQs on many regulatory topics.

The System is guided by the following seven cooperative principles shared by other co-ops around the world:

1. **Voluntary** and open membership.
2. **Democratic** member control.
3. **Members'** economic participation.
4. **Autonomy** and independence.
5. **Education**, training, and information.
6. **Cooperation** among cooperatives.
7. **Concern** for community.

- **FCA Examination Manual.** The FCA Examination Manual contains concepts, guidelines, and procedures for the examination of FCS banks, associations, and service corporations.

We distribute most of these documents by email to the board chairs and managers of System institutions and post them on our website at www.fca.gov.

Although these various forms of guidance provide valuable information, they do not have the force and effect of law and regulations. Rather, the guidance is designed to help System institutions comply with applicable laws and regulations and to improve communication between FCA and System staff.

Examination

At least once every 18 months, FCA examines your institution to ensure that it does the following:

- Operates in a safe and sound manner
- Complies with applicable laws and regulations
- Continues to fulfill its congressionally mandated mission

As part of every examination, we prepare a Report of Examination that details our examination activities and conclusions. We first present this report to your institution in writing and later present it orally to your board and management.

Our examinations and oversight strategies focus on your institution's financial condition and any material existing or potential risk, as well as on the ability of your board and management team to direct operations. Our examiners evaluate your institution's compliance with laws and regulations. They also evaluate whether your institution has fulfilled its mission to serve the credit and related services needs of all eligible borrowers, including young, beginning, and small farmers and ranchers.

If your institution violates a law or regulation or operates in an unsafe or unsound manner, we use our supervisory and enforcement authorities to achieve appropriate corrective action. These authorities are discussed later in this booklet.

Financial reports

Like all other System institutions, your institution submits financial data to FCA every quarter through the Uniform Call Report. Almost all the data submitted through the Uniform Call Report are available to the public through the FCA website. From the data we receive, we generate and publish on our website three types of financial reports. These reports allow you to compare your institution's financial performance with that of other institutions.

- **Uniform performance report.** This report provides a condensed balance sheet and income statement for each institution, as well as information on the institution's capital, assets, earnings, liquidity, and sensitivity to interest rate risk. Four reporting periods are represented — the current quarter, the same quarter 12 months earlier, and the two most recent year-ends.

- **Uniform peer performance report.** This report provides a comparison of one institution with a group of institutions of similar asset size. With this report, you can assess your institution's overall performance, capital adequacy, asset quality, earnings, and liquidity.
- **Six-quarter trend report and six-year trend report.** These reports provide information from six consecutive reporting periods.

From our website, you may also generate institution comparison reports of up to six institutions. In addition, you may generate reports by district, as well as Systemwide reports by type of lender.

Most reports are available for active and inactive institutions back to March 1989. However, Uniform Peer Performance Reports go back only to 1993.

YBS reports

Your institution, like other System institutions, also submits a YBS report to FCA. This annual report describes your institution's lending and related-service activities to young, beginning, and small farmers and ranchers.

You may view YBS data on our website by individual institution, by district, or across the System. The YBS reports present data for only one reporting period and go back to 1999.

Other resources provided by FCA

You may find the following resources, available at www.fca.gov, helpful while serving as a director. If you do not have access to the internet, call 703-883-4056 to request paper copies of these resources, as well as copies of the Director's Role.

- **FCA Annual Reports.** These reports provide information about FCA and the financial condition and performance of the Farm Credit System.
- **The Role of Farm Credit System Nominating Committees.** This brochure describes the responsibilities of bank and association nominating committees in the director nomination process.

The Farm Credit System Insurance Corporation

As a board director, you should also be familiar with the Farm Credit System Insurance Corporation (FCSIC) and its importance to System investors. FCSIC is a federal government-controlled corporation created by Congress in the wake of the agricultural credit crisis of the 1980s to renew investor faith in the financial integrity of the System.

FCSIC is administered by a board of directors made up of the same individuals serving on the FCA board. The chair of the FCSIC board of directors is elected by the other directors and may not serve concurrently as chair of the FCA board.

FCSIC insures the timely payment of principal and interest on obligations issued jointly by FCS banks to investors. If an FCS bank is unable to make a payment to

investors on a Systemwide debt security, FCSIC will pay investors out of the Farm Credit Insurance Fund, which FCSIC administers. It has built and maintains the Farm Credit Insurance Fund by collecting insurance premiums from FCS banks. These premiums are calculated using a statutorily defined formula. Premium rates are generally based on each bank's pro rata share of insured debt.

Congress directed FCSIC to build the Farm Credit Insurance Fund to a "secure base amount," defined as 2% of the aggregate of all outstanding insured obligations of FCS banks, adjusted downward by certain percentages of the System's government-guaranteed loans and investments. FCSIC may collect from 0 to 20 basis points annually on adjusted insured debt outstanding and may also assess a risk surcharge of up to 10 basis points on nonaccrual loans and other-than-temporarily impaired investments.

For current information about the Farm Credit Insurance Fund's secure base amount and insurance premium rates, go to the FCSIC website at www.fcsic.gov or contact FCSIC by phone at 703-883-4380.

FCSIC may also provide financial assistance (subject to certain limits) if FCS banks and direct-lender associations experience significant financial difficulty. This assistance may include the following:

- Providing loans or contributions
- Purchasing assets and debt securities
- Assuming liabilities
- Facilitating consolidations and mergers

In addition, FCSIC will be the conservator or receiver of any FCS bank or association that is placed into conservatorship or receivership by the FCA board. Another responsibility of FCSIC is to ensure the retirement of eligible borrower stock at par value.





A System institution's board of directors: Its structure and composition



System institution's board of directors, like that of any other corporate organization, oversees the management of the institution. In performing its duties, your board is to follow your institution's bylaws and FCA rules.

When determining the size and selection of your board, your bylaws should address the following:

- The number of directors on the board
- The length of the directors' terms
- The qualifications director-candidates must meet
- How directors are elected and removed

Your board's size should be large enough to provide adequate voting stockholder representation and to ensure that it has the 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 to avoid developing the rubber-stamp mentality frequently associated with larger boards.

Diversity and inclusion

The Farm Credit Act, in furtherance of the System's cooperative structure, expects an institution's board of directors to reflect its borrowing base. This includes representing not only the geographic areas and commodities financed by the institution, but also the age, race, and gender of existing and potential borrowers.

Outside directors and other appointed directors

Although the board of a System institution is primarily composed of stockholder-elected directors, each FCS bank and association is required by the Farm Credit Act to have at least one outside director. FCA regulations further require FCS banks and medium-to-larger associations to have no fewer than two outside directors. The regulations allow associations with \$500 million or less in total assets to have just one outside director. However, if the board of an association with over \$500 million in total assets is so small that the addition of a second outside director would result in less than 75% stockholder-elected representation on the board, the association is exempt from the requirement to have a second outside director.

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. FCA regulations discuss the independence requirements your institution must follow when selecting outside directors. These regulations also address specific requirements for eligibility, number, terms of office, and removal.

In addition, as explained in the booklet "Farm Credit Bank and Association Appointed Directors" (BL-009 Revised), FCA has not objected when FCS bank and association boards of directors have appointed a limited number of voting stockholders to serve as directors to add diversity or to acquire needed skills that cannot otherwise be acquired by election or through use of the statutory authority to appoint outside directors. Directors appointed for these purposes are known as "other appointed directors."

However, in keeping with cooperative principles, the majority of the directors on an institution's board must be elected by the collective action of voting stockholders. While the board may add more than the minimum number of outside directors and use other appointed directors, under no circumstances may stockholder-elected board representation drop to less than 60%. In other words, the combined total number of outside directors and other appointed directors serving on a board may never exceed 40% of the total number of directors on the board. A board's quorum level should also ensure elected directors compose the main part of the quorum to further protect the shareholders' voices and the cooperative structure of the institution.

Financial experts

Your 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 a financial advisor to counsel the board. The financial advisor is not a member of the board but must report to the board of directors and must not be affiliated with the external auditor or institution management.

So who exactly is a financial expert? A financial expert is someone recognized for having education or experience in accounting, internal accounting controls, or in preparing or reviewing financial statements for financial institutions or large corporations. The financial expert for your institution should have experience with accounting and financial reporting issues similar to issues that could reasonably be expected to arise in your institution's financial statements.

If you need help determining whether someone has the qualifications to be considered a financial expert, see "Financial Expert Determination," a decision tree on our website at www.fca.gov.

Board committees

Matters that require detailed review or analysis may best be addressed by a committee of the board rather than by the full board. A board committee is composed of a smaller group of directors acting as an extension of the board. Its purpose is to focus the efforts of its members on a particular subject and thus assist the board in

carrying out its fiduciary duties and managing workload. Your institution's board is required to form two types of committees:

- Audit committee
- Compensation committee

Boards may identify other areas that also could better be handled by committee. Many institutions have optional committees, such as an executive committee, a governance committee, a credit committee, or a risk committee.

While your institution also is required to have a nominating committee, the nominating committee is a stockholder committee — not a board committee. Nominating committees are key to the director election process and are discussed later in this booklet.

Board committees provide good opportunities for directors. You can gain specialized knowledge of your institution's business by serving on a committee. In fact, you may wish to serve on one committee for a while, then rotate to serve on another. Rotating committee assignments allows you to broaden your knowledge and understanding of your institution's operations.

Audit committee

The primary purpose of the audit committee is to help the board of directors oversee internal controls over financial reporting. Board members selected for the audit committee should be well qualified and able to operate independently of management. FCA regulations require that this committee report only to your board and not to your institution's management team. Processes should be in place to verify that audit committee members have the knowledge and independence they are required by regulation to have.

Guidelines for board committees

Draft a charter. When creating a board committee, draft a charter defining the committee's mission, authorities, responsibilities, reporting expectations, size, 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.

Provide committees with support and resources. Ensure that each board committee receives the support and resources it needs to carry out its duties.

Identify the knowledge and skills that committee members need. To effectively address the issues before the committee, its members may need to have specific technical knowledge and experience.

Provide training and access to experts. For board committees requiring specialized skills or knowledge, ensure that committee members receive any necessary training and have access to third-party experts.

Require reports. Require regular reports from each board committee to ensure that your board can make decisions in a timely manner.

Review committee recommendations. If a board decision is made based on a board committee recommendation, be sure the committee has done its work responsibly and that its recommendations are reasonable. Establishing a board committee to handle certain matters does not normally relieve your board of any accountability for decisions related to those matters.

These are some of the regulatory requirements regarding the composition of the audit committee:

- The audit committee must be composed solely of directors, and it must have at least three directors.
- The committee must have at least one member 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 for the audit committee who is a financial expert.
- Members of the audit committee must have some knowledge of public and corporate finance, financial reporting and disclosure, or accounting procedures.

Aside from these requirements, your board has considerable discretion in defining the qualifications it wants each audit committee member to have. Your institution should provide a training program in appropriate financial areas for any directors who do not have sufficient financial knowledge to serve on an audit committee. We encourage all directors to receive ongoing training and development to enhance their knowledge and skills.

According to FCA regulation, your institution's audit committee has the following responsibilities:

- To oversee the preparation of financial reports and your institution's system of internal controls, including controls relating to compliance with applicable laws and regulations
- To hire, and oversee the work of, the external auditor, ensuring that the auditor objectively assesses your institution's financial reporting practices while minimizing undue management influence in the review of financial reports and accounting procedures
- To recommend actions needed to provide full and accurate disclosure of your institution's operations in the most transparent manner possible
- To maintain records of audit committee meetings for at least three fiscal years

Compensation committee

The purpose of the compensation committee is to ensure that your institution's compensation policies and procedures encourage improved or continued performance, while not jeopardizing the goals and objectives of business and capital plans nor adversely affecting safe and sound credit decisions. Your institution's compensation policies should address not only the salaries provided to senior officers and employees, but other benefits as well, including compensation programs. If the CEO's performance evaluation is tied to compensation, the compensation committee may also be responsible for completing the CEO's performance evaluation and making a report to the full board.

Requirements regarding the composition of the compensation committee include the following:

- The committee must have at least three members, and all committee members must be members of the institution's board of directors.
- Each member of the compensation committee must be free from any relationship that would interfere with his or her independent judgment as a committee member.

A board committee performing the duties of the compensation committee, with a charter that satisfies compensation committee requirements, may fill the role of a compensation committee, even if it is not called a compensation committee.

The compensation committee has the following regulatory responsibilities:

- To review the compensation plans and policies for senior officers and employees
- To approve the overall compensation program for senior officers
- To maintain records of committee meetings, including attendance, for at least three fiscal years

FCA booklet "Compensation Committees" (BL-060) provides additional information and guidance on the structure, operations, and oversight of the compensation committee.

Stockholder-controlled nominating committee

The nominating committee is not a committee of the board; rather, it is a committee of stockholders who own voting stock. It is responsible for identifying, evaluating, and nominating candidates for election to the board of directors of an FCS bank or association.

The nominating committee's independence from the influence of the board and management is critical to the success of your financial cooperative and the preservation of stockholder control. For more information, see the following resources on our website at www.fca.gov:

- "The Role of Farm Credit System Nominating Committees"
- "Guidance on Farm Credit Bank and Association Nominating Committees" (BL-043 Revised)

Please note that the nominating committee is not the sole source of nominations for open director seats: The Farm Credit Act specifically provides for nominations from the floor. Floor nominations come after the nominating committee has presented director-nominees but before ballots are prepared.



A System institution's board of directors: Its responsibilities and roles

Good board governance is a commitment you and your fellow directors make to your role as representatives of your institution's shareholders and to a set of values and ethical conduct. In a cooperative, good governance starts with the directors' acknowledgement that the shareholders are the owners.

Together, you and your fellow board members are accountable to shareholders and investors for the following:

- Understanding your institution's operations
- Providing competent management for your institution
- Establishing systems and processes that support safe and sound operations
- Diligently and impartially performing your duty as directors
- Exercising independent judgment while remaining loyal to your institution's interests

The board establishes policies and strategies that govern how your institution carries out its business and ensures that those strategies and policies are implemented. You and your fellow board members should select and evaluate competent senior management and monitor and assess their performance.

The board delegates day-to-day operations to management but remains responsible for ensuring the institution operates within prescribed policies, in compliance with laws and regulations, and in a safe and sound manner.

What are the specific responsibilities of a board of directors? The board of directors is responsible for the following:

- Establishing policies
- Providing strategic direction
- Hiring the CEO and providing for a plan of succession
- Overseeing activities performed by management
- Overseeing all major functions of the institution
- Ensuring that information and disclosures to investors and shareholders are accurate, understandable, and reliable

The board's effectiveness will depend, in part, on how well you and your fellow board members know your institution. Together, you must have the knowledge and skills to carry out your duties; therefore, you must diligently strive to understand the operations of your institution and seek training where needed. You should also understand the industry and the community in which your institution does business. The effectiveness of your board will also depend on how well you work together to identify and address issues.

Both agricultural production and the financial services sector within which the System operates experience continual change. Generally, these changes create additional risks for institution operations and for institution borrowers. Your board has both fiduciary and regulatory obligations to continually reevaluate its skill set in light of these changes.

By regulation, your board must have director training policies and programs that meet your institution's needs. If you are a new director, you must receive training in all aspects of the institution's operations within one year of your election to the board. Even if you are not a new director, you must take training periodically to update your knowledge and skills.

Also, FCA regulations require that your board have a policy that identifies the desirable qualifications for directors. The policy must explain why those qualifications are desired, must be periodically updated, and must be provided to the institution's nominating committee.

The following sections discuss seven important roles that the board of every Farm Credit System institution should fulfill:

- Ensuring mission achievement
- Providing business planning and strategic direction
- Making policy
- Providing oversight
- Setting internal controls
- Governing information technology activities
- Setting compensation

Ensuring mission achievement

One of the board's most important roles is ensuring that the institution accomplishes its mission, goals, and objectives. The mission of the Farm Credit System is clearly described in the Farm Credit Act: 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 fulfill this mission, your institution must function under cooperative principles. Core cooperative principles include member benefits, member ownership, and

member control. The guidelines in the box below will help to ensure that your institution adheres to these cooperative principles.

Providing business planning and strategic direction

Another important role for the board is to provide business planning and strategic direction. The business planning process enables the board to identify strategies to achieve its vision. Because effective planning is essential to institutional health, all directors need to be fully involved in the planning process. Planning can be used as a tool to chart progress and to maintain sound operations during periods of uncertainty and change. Planning is vital to the long-term success of your institution because it translates the board's vision into measurable goals with strategies to achieve them.

At its core, business planning is the process of determining where your institution is, where it would like to be, and how it plans to get there. The planning process should be dynamic and ongoing. It involves detailing strategies for attaining the short-term, sometimes routine, goals of business operations, as well as long-term goals.

A good business plan consists of two parts:

- **Strategic plan**, which focuses on the long-term deployment of resources to achieve institutional goals and meet the needs of stockholders and the broader agricultural community. The strategic plan states the board's overall philosophy and its vision of the institution's future.
- **Operational plan**, which concentrates on short-term actions. This plan helps institutions achieve long-term goals by translating them into specific, measurable targets.

The purpose of the business plan is to identify the areas selected for strategic development, allocate resources, and provide the basis on which business decisions can be made and performance can be measured.

Several strategies may be involved in achieving a goal. If, for example, the goal is to attain a certain net worth position, the business plan would incorporate strategies to retain capital, increase earnings, and grow assets. Your board should ensure that

Guidelines for adhering to cooperative principles

Promote stockholder participation. Actively seek and encourage stockholder participation in setting the direction for the institution.

Study the cooperative principles of your institution. Understand the distinctive cooperative principles and philosophies your institution holds and be aware of their implications for member benefit, member ownership, and member control.

Promote service to all eligible and creditworthy borrowers. Ensure that your institution offers credit for all types of agriculture practiced within its chartered territory by developing plans and policies that extend the full range of System benefits to all types of eligible borrowers. The System's cooperative benefits, ownership, and control should be available for all types of producers, including underrepresented groups. And remember that programs for young, beginning, and small farmers are specifically required.

Guidelines for planning

Identify strengths and weaknesses. Identify your institution's internal strengths and weaknesses, as well as any external opportunities and threats. A thorough understanding of your institution's operating environment allows your board to design goals and strategies to best meet the mission of your institution.

Identify the resources and capabilities your institution needs. Determine what financial and human resources, as well as what technological and organizational capabilities, your institution will need to achieve the board's long-term vision and goals.

Identify, analyze, and address risk. By doing so, you can discover the causes of these risks and how they may affect future performance. Also, defining risk helps you make projections and determine the financial resources you'll need to address those risks. Once risks are defined, the board may require management to explore various methods for managing your institution's exposure to these risks.

Establish reporting requirements. You will need to have reporting requirements for each component of your plan and review your institution's performance at least quarterly to evaluate the appropriateness of both the strategic and operational components. As part of the review, consider new opportunities, changes in the operating environment, and external developments to decide whether adjustments to the strategic direction are needed.

Establish contingency plans. In case actual results vary from planned goals and objectives, you will need to have contingency plans to get your institution back on track.

its strategies and the use of institution resources will reasonably accomplish the intended purposes. See the guidelines for planning in the box to the left.

Capital adequacy planning

FCA regulations require your institution's board of directors to establish, adopt, and maintain formal written capital adequacy plans as part of its financial plans. Your board is responsible for assessing capital needs and setting capital goals. Capital should be sufficient to ensure your institution's stability and viability, support asset growth, and contribute to your institution's earnings base. As a director, you are responsible for ensuring that your institution has sufficient capital to accomplish its mission and achieve its capital goals. Your board is also responsible for governing your institution's capital distributions.

Appendix A discusses capital planning in greater detail. We also encourage you to review the capital management section of our Examination Manual (EM-11.2).

Human capital and marketing planning

FCA regulations that govern operating and strategic business planning require System institutions to develop human capital and marketing plans that promote diversity and inclusion. The human capital plan is to include strategies and actions for how the institution will strive for diversity and inclusion within its workforce and management.

Each direct-lending institution is required to have a marketing plan that shows how the institution will help meet the System's objective of being responsive to all types of agricultural producers who are creditworthy and eligible for System funding.

The marketing plan must describe the institution's chartered territory by market segment, including demographic and geographic characteristics and the types of agriculture practiced in the territory. It should also contain strategies and actions for marketing the institution's products and services to all eligible and creditworthy persons, with specific outreach toward diversity and inclusion within each market segment.

Finally, FCA regulations require each institution to report annually to its board of directors on the progress

it has made in accomplishing the strategies and actions in its human capital plan and marketing plan.

We encourage you to review sections EM-31.2, EM-31.4, and EM-31.5 of our Examination Manual for further discussion on this topic.

Making policy

As a board member, you have the role of setting policy for your institution. When making policy, boards should consider the following:

- Has your institution established all the policies required by statute or regulation?
- What policies are needed to address specific institutional programs or activities?
- Does your institution's charter or bylaws identify areas requiring policy direction?
- Should policies be developed related to industry standards, emerging issues, and guidance provided by FCA and other authoritative sources?

The board typically establishes broad guidelines for a given policy but then delegates the responsibility of working out the detailed aspects of the policy to a board committee or to management. After providing policy guidance, management has the task of drafting the procedures to implement the board's policy. For guidelines on developing effective policies, see the box on the following page.

No matter how policies are developed, they are ultimately approved by the board, and the board remains responsible for them. Before approving policies, you and your fellow board members must ensure that they are appropriate for your institution and supportive of strategic objectives. And since the board is ultimately responsible for the success of your institution, board-approved policies must provide sound direction to management.

In addition, the board should periodically evaluate whether policies are accomplishing their intended goals and objectives. The board should schedule a review of certain policies at board meetings or designate a committee to review policies on a regular basis. 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. Also, your institution's internal auditor should evaluate the effectiveness of these policies and procedures.

The board must ensure that policies adequately direct and control the business affairs of the institution. That's why the board should reevaluate and revise policies as necessary. The board is also responsible for ensuring that policies are thoroughly followed at all levels of the institution. One way to do this is to create a policy manual that serves as a single authoritative reference. For more complicated policies and procedures, training programs may be helpful.

Guidelines for effective policies

Define the purpose of the policy. A statement of purpose clearly articulates the policy's goals.

Identify your policy objectives. Policy objectives may be simple statements that require your institution to comply with a specific law, regulation, or business practice. Objectives may also 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.

Determine your operating parameters. Each policy should specify the parameters within which management and staff are expected to operate, and these parameters should be consistent with sound business practices, FCA regulations, applicable laws, and generally accepted accounting principles. The parameters should protect the safety and soundness of your institution by controlling risk in a way that is compatible with your institution's risk-bearing capacity and considers its effect on earnings and capital.

Delegate appropriately. 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 parameters for concentrations of risk in various portfolio segments or limits on loan size in relation to your institution's capital base. In such instances, the 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. Since the board remains responsible for actions taken by others under its delegated authorities, it should include reporting and controls within any delegation.

Identify exceptions to board policy. Unexpected and urgent matters may arise that require management to act immediately and to exercise greater authority than it has been delegated by the board. The board's policy should clearly define a process to handle such contingencies; the policy should also set the consequences if the board determines the action was inappropriate.

Define reporting requirements. Each policy should clearly define the requirements management must meet when reporting to the board. 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 enable you and your fellow board members to evaluate a policy's effectiveness and impact, as well as to remain informed of your institution's operations. The reports should also include actions taken under delegated authorities and actions taken as exceptions to policy.

Providing oversight

Although the board and management are both involved in directing the operations of the institution, the board of directors has ultimate responsibility for providing strong oversight of your institution's performance. Executive sessions are an effective way for you and your fellow board members to address your oversight responsibilities. These sessions occur in connection with regularly scheduled meetings, but institution officers or staff are not present. This approach facilitates open and candid discussion among directors.

To provide effective oversight, your board must do the following:

- Ensure that your institution accomplishes its mission
- Perform self-evaluations and adhere to ethical principles
- Maintain a proper relationship with management
- Evaluate your institution's business and financial performance
- Assess your institution's operational performance and asset quality

The board should also ensure that your institution's operations are transparent and that the reports and disclosures to stockholders, investors, and the public are truthful.

Evaluating business and financial performance

Evaluating your institution's business and financial performance involves more than just looking at the amount of earnings; it also involves determining the quality of the earnings and the institution's ability to sustain those earnings. To evaluate the quality of earnings, you need to understand your institution's entire financial and credit operations, as well as the relationships among operating statistics.

Likewise, to evaluate your institution's financial and credit operations, you need to understand the relationships among interest-earning assets, interest-bearing liabilities, capital, and off-balance-sheet items such as derivatives. To understand these relationships, you should receive training in all aspects of your institution's business.

Quality earnings result from fundamental institutional strengths, such as the ability to do the following:

- Identify and manage risks
- Identify quality assets that can weather adversity
- Control expenses
- Apply effective asset-liability management, proper loan pricing, and knowledge of your institution's operating environment

Your board should evaluate your institution's business carefully, looking behind the numbers to verify that earnings are not artificially inflated by delays in charge-offs, insufficient provisions for loan losses, and other factors. Regular reports by your institution's audit committee, as well as FCA examination reports and reports by independent public accountants and internal reviewers, may help you ensure the

reliability of reports to the board, shareholders, investors, and the public. CEO and chief financial officer attestations on financial reports are designed to help ensure accuracy in financial reporting.

You and your fellow board members should be able to discern poor operating performance; however, you may not all have enough experience in complex financial matters to independently evaluate your institution's financial performance. For this reason, directors have the authority to enlist the help of an independent financial expert. (See "Financial Experts" on page 14.) We also strongly encourage you to seek training under the institution's director training program to enhance or reinforce your financial knowledge and skills.

Although there are no ratios or computer model results that guarantee success, certain accepted business ratios can be guides to the success or failure of your institution. Your board needs solid financial data and should ensure that analyses are performed to provide an accurate picture of your institution's financial and operating performance. In considering your institution's performance, ask yourself 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 your 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 on long-term indicators?
- Are findings from internal and external audits and reviews routinely delivered to the board or the audit committee?
- Does the charter of the audit committee provide the committee with adequate authority and clearly describe its responsibilities? Is there adequate financial expertise on the committee?

As a director, you are not expected to have all the answers, but you should ask questions and ensure that you receive responsible answers. The guidelines on the following page will help.

Assessing operational performance and asset quality

The principal assets of your institution are the loans it makes. The quality and performance of those assets are of paramount importance to your institution. The numbers of performing, criticized, adversely classified, restructured, high-risk, past-due, and nonearning assets reflect the quality of assets and directly affect your institution's overall operational performance and condition.

Poor asset quality may reflect weaknesses in the institution's loan portfolio management practices, which require prompt corrective action. Loan portfolio management involves the systems, processes, and controls the board and management use to plan, direct, organize, and control lending operations.

Some of the key components of an effective portfolio management system include the following:

- Strategic portfolio planning, including stress testing
- Lending policies and procedures
- Loan underwriting direction
- A reliable risk identification program
- Clearly defined risk parameters for various portfolio concentrations
- An internal credit and collateral review program

While not all-inclusive, the guidelines on the following page will help you evaluate your institution's loan portfolio management practices.

Any institution can encounter problem credits. Sometimes they result from a breakdown within the institution, which requires quick board action to address the problem that led to increased risk. Sometimes they result from unforeseen circumstances beyond the institution's control, such as disruptions in the agricultural economy or natural disasters.

Whatever the cause, it is important to give problem credits close attention. A correction or collection plan should be put in place for each troubled credit. Occasionally, your board may wish to approve the individual plan and receive periodic progress reports if there is

Guidelines for evaluating business and financial performance

Be proactive. Don't wait until problems arise to ask key management employees questions regarding your institution's condition and performance. Ask them periodically.

Attend every board meeting. Arrive prepared, having reviewed all available information in advance.

Ask questions. Ensure that you fully understand the documents and transactions you are asked to approve and the risks associated with the transactions.

Make informed decisions. If something is confusing, get a satisfactory explanation from management or an outside expert — and insist that all decisions be well documented.

Insist that you receive appropriate financial information. You will need this information to evaluate your institution's performance. This guideline is particularly important if you are a member of the audit committee.

Make sure you're getting the right amount of information. Management should provide you with the right amount of information. More isn't always better because too much detailed information and too many reports can keep you from focusing on the key issues. At the same time, too little information can leave unanswered questions.

Verify that the audit committee has adequate financial expertise. Your board relies on the audit committee's financial expertise to help it conduct its fiduciary responsibilities to stockholders.

Require regular reports from the audit committee. The full board should receive regular financial reports, including key financial ratios and data on operational performance.

Be sure you understand financial and asset-quality ratios. You will need to understand the significance of these ratios, as well as trends. Appendix A of this booklet discusses several key financial ratios to help you understand and track your institution's financial performance.

potential for large losses. But in all instances, your board should ensure that plans are put into place and that those plans — as well as applicable regulations — are followed.

A neglected problem credit is more likely to result in a loss than one that is well administered. Although deviations from acceptable asset quality may occur periodically, you and your fellow board members are ultimately accountable for ensuring that lending programs preserve and enhance your institution's tier 1 capital and further the System's public policy mission regardless of the operating environment.

Guidelines for evaluating portfolio management practices

Review lending policies and underwriting standards. Ensure that appropriate lending policies and underwriting standards are in place for your institution and are periodically updated to reflect current credit conditions.

Evaluate stress testing. Ensure that management conducts portfolio stress testing to predict portfolio risks under a variety of conditions.

Consider risk concentrations. Provide clear direction for managing risk concentrations and ensure that processes and controls are in place.

Review the results of internal credit reviews. Closely monitor the findings of the internal credit review and any weaknesses discovered in lending processes and practices. This includes monitoring corrective actions to address audit findings. Monitoring the results of internal credit reviews is particularly important for board members who also serve on the audit committee.

Ask questions about quality or volume changes. Require management to fully explain any variation in the quality or volume of loans to ensure that you understand the reason for any changes in your institution's position. Asset quality statistics should clearly and concisely show both the institution's current position and its historical trends. For example, monitor credit classifications, risk ratings, nonaccrual volume, and distressed loan servicing/restructuring activity.

Performing self-evaluations and adhering to ethical principles

You and your fellow directors are responsible for evaluating your effectiveness as a board in (1) achieving safe and sound operations and (2) operating within applicable laws and regulations. FCA regulations require annual board evaluations, as well as strategies for correcting any identified weaknesses. Your 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, including the work of committees, for both existing and projected circumstances. Board evaluations are ideally performed in connection with the annual planning and review of your institution and its management. Board evaluations are also a useful tool for identifying board training and development needs.

Finally, developing a code of ethics will help ensure that you and your fellow board members provide proper oversight of your institution, especially if you do the following:

- Review the code on a periodic basis
- Distribute the code to all appropriate parties
- Prominently display and adhere to the code

Sound ethics, adherence to standards of conduct, an effective whistleblower program, and sufficient director training and expertise are all essential to effective oversight.

Maintaining a proper relationship with management

The board has the ultimate responsibility for the affairs of your institution. To fulfill this responsibility and protect your institution's future, the board must make sure that day-to-day operations are properly managed. At all times, you and your fellow directors must ensure that management is carrying out your institution's mission and goals. Although your board may delegate certain authorities to the institution's officers, take care that the delegation is not too broad, and make sure it has appropriate standards and oversight. Also, remember that no delegation will relieve you and your fellow board members of your legal responsibilities for the outcome.

Generally, a sound and successful operation is led by a good management team. That's why the board's duty in hiring and retaining effective managers is one of the most critical elements to the institution's success. The quality and strength of your institution's management may be the difference between success and failure during difficult economic times or swings in the rural economy.

The guidelines on the next page may help you and your fellow board members ensure that your institution is properly managed.

Guidelines for ensuring proper management

Hire a CEO who has integrity and the right experience. When hiring the CEO, consider each candidate's integrity, education, technical competence, and lending and management experience.

Promote cooperative principles to your management team. Ensure that management not only understands the cooperative philosophy and principles upon which your institution is based but is committed to implementing them.

Instill an ethical culture. Ensure that your management team establishes a strong ethical culture for your institution. Be sure that the team understands that the reputation of your individual institution affects the reputation of the System as a whole.

Promote a positive and professional work environment. Make sure that management maintains a professional work environment. Make sure that the institution abides by applicable antidiscrimination laws and regulations. Also make sure that proper procedures are in place to report and investigate allegations of violations of antidiscrimination laws and regulations.

Establish clear performance standards and measures. Provide clear performance standards and measures to ensure that managers fully understand the board's performance expectations and are accountable for fulfilling those expectations.

Institute a formal process for performance management. Consider using the compensation committee, or another board committee, to institute a formal process to evaluate management performance and ensure that periodic evaluations are a part of the ordinary course of business. When evaluating management, you may wish to use the following performance measures:

- Your institution's business success and fulfillment of its public policy mission
- Your institution's compliance with applicable laws and regulations
- Management's responsiveness to board directives
- The timeliness, quality, and accuracy of management's recommendations and reports to the board
- The degree to which management adheres to the institution's business plan
- The degree to which your institution's objectives have been achieved
- Actual versus projected performance
- Comparisons with similar institutions
- FCA reports of examination, internal and external audit reports, and internal business performance and credit quality indicators

Do not ignore poor performance or wrongdoing by management. If performance expectations are not being met, deal with the situation immediately. Although timely and effective communication may prevent serious problems from developing, occasionally the board will find it necessary to discipline or dismiss managers for poor performance, dishonesty, conflicts of interest, or other reasons. All such actions should be properly documented in the institution's official records.

Develop a succession plan for the CEO. Review contingency plans annually and include succession planning for the other critical management levels, including the chief financial officer, the chief credit officer, the general counsel, and the chief information officer. If no individual in your institution is identified to succeed the CEO, the board should at least identify a competent and experienced temporary replacement in case there is an unexpected CEO vacancy.

Setting internal controls

FCA emphasizes the need for strong internal controls at System institutions, including controls in the areas of credit, operations, information technology, internal controls over financial reporting (ICFR), and other areas. Effective internal controls provide reasonable assurance that the following objectives will be achieved:

- Operational objectives (such as financial performance goals and protecting assets against loss)
- Reporting objectives (including internal and external financial and nonfinancial reporting that is reliable, timely, transparent, and in compliance with laws and policies)
- Compliance objectives (which involve adhering to laws and regulations)

FCA regulations require each System institution board of directors to adopt an internal control policy that provides direction in establishing effective control over and accountability for operations, programs, and resources. Without an effective system of internal controls, your institution could be exposed to fraud, financial loss, legal consequences, additional regulatory expectations, and reputation risk.

Three lines of defense. There are three core lines of defense in an institution's risk management strategy:

- The first line of defense is operational management, consisting of business and process staff whose activities create and/or manage the risks facing the institution. Their actions can either facilitate or prevent the achievement of an organization's objectives.
- The second line of defense involves the risk management and compliance functions that monitor risks and support the controls that management oversees. Inadequacies here can delay discovery of risks.
- The third line of defense, internal audit, provides independent assurance to the board and senior management concerning the effectiveness of management of risk and control.

Each line plays a distinct role within your institution's governance framework. For more information, we encourage you to read the Institute of Internal Auditors position paper, "Three Lines of Defense in Effective Risk Management and Control"; the paper is available on the institute's website at <https://na.theiia.org>.

Internal audit and review. An effective internal audit and review program is an essential component of an institution's internal control system. The internal audit and review program evaluates and provides assurances on the effectiveness of the institution's internal controls, risk management, and governance processes. The board is accountable for establishing, overseeing, and maintaining an effective internal audit program. This means the board or audit committee should be involved in internal audit planning and scoping, oversight of corrective actions and audit progress, and the selection of the chief internal audit staff and any third-party internal audit firms.

Financial reporting. The importance and relevance of ICFR to stakeholders, investors, regulators, audit committees, management, and auditors continue to grow. Management is responsible for monitoring compliance with FCA regulations to ensure the institution has established and maintains adequate ICFR.

ICFR enhances the quality of reporting by identifying potentially damaging practices within your institution. And as noted earlier, your audit committee is responsible for oversight and review of your institution's system of internal controls over financial reporting.

It has been shown that ICFR improves when the audit committee, management, and the auditor acknowledge the importance of ICFR and work together to improve the institution's ICFR. In addition, the Federal Farm Credit Banks Funding Corporation has the unique responsibility of reporting consolidated Systemwide financial information, which includes information about ICFR, to investors and the public. This

financial information is key to maintaining a sound reputation and investor confidence in Systemwide debt.

Guidelines for IT

Approve IT plans. Approve IT-related plans, policies, and major expenditures while ensuring that management has an effective IT strategy that aligns with the overall enterprise strategy.

Understand your institution's IT infrastructure and risks. Learn about your institution's IT infrastructure and its components and be aware of key IT topics, such as IT security policies, data center concepts and activities, and IT-related risks. Be aware of key IT development and acquisition projects and how they support and affect overall corporate strategies, objectives, and short- and long-term budgets.

Implement an IT control framework. Insist that your institution implement an IT control framework, including IT policies and procedures that are designed to ensure your institution's safety and soundness and compliance with law, regulations, and accepted practices essential for a functioning IT system.

Require reporting. Require regular reporting on IT system functionality and security, including periodic reporting by your institution's chief security officer, to the board or a committee of the board (such as the audit or risk committee).

Include IT security and operations in the internal audit review. Ensure that your institution's internal audit and review program includes IT security and IT operations (e.g., vendor management and business continuity plans) within its audit scope and dedicates sufficient resources to these activities.

Governing IT activities

The pervasive use of technology in System institutions has created a critical dependence on information technology (IT); as a result, institutions must address IT operational issues. Boards of directors of System institutions are responsible for planning and maintaining an effective and secure IT enterprise framework.

The guidelines in the box to the left can help you and your fellow board members ensure that IT at your institution is properly managed.

Setting compensation

As a corporate entity, your institution will have a compensation program for senior officers and employees. The purpose of the program is to establish parameters for rewarding performance without compromising your institution's safety, soundness, and mission. In addition to salaries, the compensation program should also address other benefits, including the following:

- Perquisites
- Short- and long-term incentives
- Deferred compensation
- Retirement and pension programs, including supplemental pension programs for senior officers
- Executive employment and severance agreements
- Succession planning, change-of-control provisions, and retention bonuses

Your institution must follow the regulatory requirements for compensation and for disclosing information about it. You can use the guidelines below to create an effective compensation program.

Guidelines for effective compensation programs

Define your philosophy, objectives, and practices for compensation. Ensure that these practices comply with federal, state, and local laws governing employer and employee relationships.

Make sure salaries reflect the relative value of each position to your institution. Consider using salary surveys to compare compensation rates for similar positions in comparable organizations. Be diligent and prudent in your decisions regarding compensation programs.

Monitor earnings. Make sure that your institution has sufficient earnings to cover both its compensation program and other costs of operations.

Consider the future impact of your compensation program. If your institution provides deferred compensation to officers or employees, be sure you understand the future financial impact of funding the deferred compensation and address the impact it will have in the institution's long-term financial planning.

Make sure your compensation program supports overall goals. Do not allow compensation policies and plans to adversely affect the overall goals, objectives, or mission of your institution. Keep this in mind especially when considering incentive programs.

Watch out for reputation risk. Pay attention to any reputation risks that your institution's compensation program might create for the institution. Particularly during difficult economic times, be mindful of how the public and Congress might perceive your institution's compensation program.



Standards of conduct for directors

As a member of the board of directors, you owe fiduciary duties to your institution and its members. These duties are typically described as the duties of due care, obedience, and loyalty. In other words, as a director you are expected to diligently carry out your duties in good faith and in the best interest of your institution and its members, while exercising unbiased, independent judgment.

In addition, if you are an elected director, you face another challenge because you yourself are a borrower of your institution. Therefore, you must be objective when you take actions that may affect your interests as a borrower and consider recusing yourself from any decision that is too personal to your 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 and the collective interest of its members. You should evaluate issues in terms of the institution's resources and capabilities, the reasonableness of risk and returns, any potential adverse effects on the institution and its members, and the requirements of the Farm Credit Act. In addition, your decision-making process is best served when you carefully consider all reasonably available and relevant facts and then reach a conclusion that you honestly and reasonably believe is in the best interest of the institution and its members.

While, in many situations, you may rely upon the advice of officers or experts and on information in business records for making an informed decision, you should only do so when you fully understand the issue and have no reason to doubt the supplied information.

As a director of a System institution, you may be held personally liable and subject to monetary penalties or other sanctions if you do any of the following:

- Engage in unsafe or unsound practices
- Fail to comply with statutory or regulatory mandates
- Breach a fiduciary duty (or permit another person to do so)

You may be held responsible either alone or jointly with other board members in FCA enforcement actions and in lawsuits brought by shareholders or investors. You can also be held liable for intentional torts (legal wrongs), such as fraud or misrepresentation, when third persons are injured, even though you took the actions on behalf of your institution.

However, allowances for honest error will be made. As a director, you may make decisions in good faith that you believe will benefit the institution and its members. Even if a decision turns out to be wrong and brings hardships to the institution, you may be able to avoid criticism provided the board can show it made that decision on the basis of its own evaluation of available information. That's why documenting the board's decision-making process is so important. Also, do not hesitate to seek legal counsel on matters affecting your role as director.

As a director, you have a specific responsibility to keep certain information confidential. Your role as director gives you access to sensitive business information for the institution at which you serve. You will also have access to individual borrower information. It is your responsibility to keep that information from release unless specifically authorized.

Conflicts of interest

As a director, you are expected to maintain high standards of industry, honesty, integrity, impartiality, and conduct when performing your duties. To maintain these standards, you must avoid conflicts of interest. In fact, to be prudent, you should avoid even the appearance of a conflict of interest.

How can you avoid a conflict of interest or the appearance of one? Before acting on any business matter for your institution, ask yourself if you (or members of your family or any close associates) could personally gain from the matter or could *appear* to personally gain from it. If the answer to the question is yes, consult with your institution's legal counsel and/or the standards of conduct officer to determine what to do. You will likely be advised to refrain from considering or voting on the matter and to refrain from trying to influence the votes of others on the matter.

In addition, as part of your responsibilities, you are required to make annual disclosures of certain personal information. You must disclose in your institution's annual report any outside business affiliations in which you serve as a director or senior officer. You must also disclose cash and noncash compensation received from third parties when you are acting in your official capacity. Noncash compensation includes gifts such as coffee, T-shirts, meals, unreimbursed payments for trips, and use of property. However, according to FCA regulations, you do not need to disclose noncash compensation if its annual aggregate value is less than \$5,000.





Business Strategy



FCA's examination, supervision, and enforcement authorities and activities

Examination

Congress requires FCA to examine every System institution at least once every 18 months. We fulfill this requirement by conducting a statutory compliance examination, but we may also conduct other examinations as necessary.

An examination is an objective assessment of whether your institution is operating in a safe and sound manner and in compliance with laws and regulations. Examination reports do not diminish your role as a director in overseeing your institution's operations. Rather, they are tools to help you monitor your institution's safety and soundness and its compliance with laws and regulations.

As discussed below, rather than applying the same level of examination to every institution, we use an approach tailored to each institution based on its degree of risk, the adequacy of its governance and internal control systems, and other factors. This approach results in a more effective and efficient examination process. Well-managed, sound institutions do not require the same amount of examination and oversight as do more complex institutions or those that are troubled.

During the examination, our examiners may find weaknesses in your institution's operations and control processes or in its compliance with laws and regulations. If so, these findings will be included in the examination report and discussed with your board at the board meeting.

The examination report is a discussion of your institution's condition, operation, and compliance with laws and regulations. It also identifies any matters requiring attention. An examination report is confidential and protected from release by law. If release of an examination report, or part of its contents, is necessary, your institution must first obtain specific written consent from the legal department at FCA. In addition to the formal examination report, FCA may issue interim activity letters throughout the examination period; these letters are also considered to be examination reports and should be treated as such.

As a director, you have a duty to address report findings, to 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, FCA will evaluate the effectiveness of your board's efforts to resolve any problems noted in previous examinations.

At the board meeting near the end of the examination process, our examiners will present their findings and respond to any questions you and your colleagues have.

You will get the most out of a board meeting with FCA examiners if you thoroughly read the examination reports and any accompanying correspondence before the meeting so that you are prepared to ask questions.

Sometimes you may not agree with all of the examiners' conclusions; however, you should always make sure you understand and fully consider the basis for the conclusions and how failure to resolve concerns could affect the safety and soundness of your institution.

Your institution's management is generally invited to take part in meetings with examiners, but each meeting should also provide an opportunity for the board members to meet in executive session with exam staff only.

After an examination, your board will receive an overall numerical rating of your institution. The system that FCA examiners use to determine a rating is called the Financial Institution Rating System (FIRS). It is similar to the rating system other federal banking regulators use. Also, on a quarterly basis, we evaluate your institution's capital, assets, management, earnings, liquidity, and sensitivity to changes in interest rates. (These six characteristics are referred to collectively as CAMELS.) FCA examiners may update your institution's FIRS rating as part of this quarterly evaluation or at any other time, as needed.

In addition to assigning an overall numerical rating to your institution, our examiners assign a FIRS rating for each of the CAMELS components. These ratings, which range from one to five (with one being the best), are explained in section EM-1.3 of the FCA Examination Manual, which is located on the FCA website. We provide you and your fellow board members with the rating results to give you additional perspective on the condition of the institution you lead, but we urge you to focus on the basis for the ratings assigned and not on the ratings themselves.

Risk-based examination approach

Historically, risks for System institutions have been concentrated in traditional lending activities. However, the complexity of institutions' consolidated risk exposure has increased over the years because System institutions now offer a wide variety of lending products. In addition, System institutions serve more diverse geographic areas and rely on electronic delivery systems. In light of this increased complexity, institution management must evaluate the different types of risk exposure the institution has and control and manage each risk according to its significance. Consolidated risk assessments should be a fundamental part of managing the institution.

Because risks vary considerably from institution to institution, FCA uses a risk-based examination and supervisory approach. Our examiners do not attempt to restrict risk-taking when it is conducted in a safe and sound manner and in compliance with laws and regulations. They do, however, seek to determine whether institution management identifies, understands, and controls the risks assumed by the institution. As an organization grows more diverse and complex, its risk management processes must keep pace. When risk is not properly managed, we will direct an institution's board and management to take corrective action. In all cases, our primary concern is for the institution to operate in a safe and sound manner, to comply with laws and regulations, and to maintain capital commensurate with its risk.

FCA mainly evaluates institution risk by how it affects capital and earnings. From an examination and supervisory perspective, risk is the potential that events, expected or unexpected, may have an adverse impact on your institution's capital or earnings.

The existence of risk — even high risk — is not necessarily a reason for concern when it is effectively managed. To put risks in perspective, examiners will evaluate whether the risks your institution undertakes are, either individually or collectively, warranted. Generally, a risk is warranted when it is identified, understood, measured, monitored, and controlled, and when your institution is backed by adequate capital to withstand the financial distress that the risk could cause. Unwarranted risks (those that do not meet these criteria) will need examination and supervisory attention. Examiners will inform your institution of the need to mitigate or eliminate excessive risks. Appropriate institution actions may include reducing exposure, increasing capital, or strengthening risk management processes.

We discuss below seven categories of risk. These categories are not mutually exclusive; any product or service may expose the institution to multiple risks. In addition, the categories 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 a borrower's failure to meet the terms of any contract with the institution or arising from a borrower'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: The current and prospective risk to earnings or capital arising from movements in interest rates. This risk primarily arises from the following:

- Differences between the timing of rate changes and the timing of cash flows (repricing or maturity mismatch risk)
- Changing rate relationships among different yield curves affecting various products (basis risk)
- Changing rate relationships across the spectrum of maturities (yield curve risk)
- Interest-related options embedded in assets and liabilities (options risk)

Liquidity risk: The current and prospective risk to earnings or capital arising from an institution's inability to meet its obligations on time 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 institution's 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, products, and services in a financial institution. Operational risk is a function of internal controls, information technology, employee integrity, and operating processes. This type of risk arises daily in all financial institutions when 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, regulations, prescribed practices, or ethical standards. Compliance risk also arises when the laws or rules governing areas such as consumer lending and 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 the following:

- Diminished reputation
- Customer flight
- Limited business opportunities
- Lessened expansion potential
- Inability to enforce a contract
- Litigation

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. Legal risk is not just 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 the following:

- Inadequate direction and control
- Imprudent business decisions
- Failure to achieve goals and objectives
- Failure to follow policy direction
- Failure to respond 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 changes.

Reputation risk: The risk to earnings and capital arising from negative public opinion. Negative public opinion can affect your institution's ability to maintain credibility as a viable institution, as well as its ability to establish new relationships with

other financial institutions. It can also affect your institution's ability to continue serving existing customers or to attract new customers. For example, even simple activities like out-of-territory lending can create reputation risk for System institutions, particularly when those activities are not properly monitored or their impact to your overall operations is not given proper consideration.

Although sometimes difficult to quantify, reputation risk can expose your 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 be very cautious in dealing with customers and the community.

Supervision and enforcement

FCA's supervision and enforcement authorities are similar to those of other federal financial regulatory agencies. These authorities provide us with the power to ensure that System institutions and their related entities comply with laws and regulations and operate in a safe and sound manner. As a director of a System institution, you should be aware that you could be held personally liable in a formal regulatory enforcement proceeding for your actions as a director.

We use three supervision levels to differentiate our supervisory programs:

- **Normal Supervision** is used for institutions that have a satisfactory risk profile, where the board and management have demonstrated the ability to take corrective actions in the normal course of operations.
- **Special Supervision** is used to remediate weaknesses in institutions that have significant weaknesses but where the board and management are considered willing and able to carry out corrective actions.
- **Enforcement Supervision** is used when an institution's risk profile is unsatisfactory and the board and management are considered unable or unwilling to carry out the necessary corrective actions.

Each situation is unique and requires a customized supervisory solution.

Congress granted FCA enforcement authorities to ensure that System institutions, boards, management, and related parties comply with laws and regulations and operate in a safe and sound manner. These authorities enable us to impose rehabilitative or punitive enforcement measures on boards of directors, officers, and other individuals.

We may use these enforcement authorities when a violation of law, rule, or regulation exists. We may also use them when an institution, director, officer, or individual engages in an unsafe or unsound practice. Enforcement actions include entering into written agreements; issuing cease and desist orders; assessing civil money penalties; and removing or suspending officers, directors, and others, or prohibiting them from participating in the affairs of a System institution.

Appendix B provides additional information on supervision levels and each type of supervisory or enforcement action available.



Conclusion: Some guiding principles

Successfully serving as a director on the board of an FCS bank or association can be challenging, but following these guiding principles will help you face the challenges.

Know the law and regulations. Read and understand the Farm Credit Act and FCA regulations. (Ask your management to provide the information or download it from the FCA website.)

Act as a fiduciary. As a fiduciary, you must think and act independently and in the best interest of your institution. Always remember that you are the stockholders' representative and are serving their collective best interests. 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 your institution and its stockholders.

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 before taking action as a director.

Delegate wisely. Business demands and legal standards that govern your institution's board require you to serve with dedication and vigilance. We cannot overemphasize the point 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 or for acting to ensure that institution operations are delegated to people who merit confidence.

Avoid conflicts of interest. Be familiar with the FCA regulations addressing conflicts of interest and standards of conduct. Before you act on a business matter for the institution, ask yourself if you (or members of your family or other close associates) stand to personally gain from a matter. If so, consult with your institution's legal counsel and its standards of conduct officer to determine how to deal with the conflict. You may need to recuse yourself from the board deliberations and the vote on the matter. When in doubt, the prudent course is often to disclose the conflict 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. Mismanagement is almost always the cause when a serious problem arises or an institution fails. You must stay keenly aware of management's activities. Your early detection of managerial problems can mean the difference between the success and failure of your institution.

Understand the "why" behind your institution's actions. If a matter is before the board for a decision or management is providing a briefing to the board about actions it is taking, be sure you not only understand what is being decided but more importantly why the action is being taken. Understanding the "why" uncovers the motivations behind the action and provides a clearer understanding of the potential impacts of the action.

Be attentive to risk. 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. To manage those risks, you and your board must establish a system that is adequate for the size and complexity of your institution's operations. Ideally, the board and management will work together to ensure that risk is adequately identified, measured, monitored, and controlled. Risk management is a continual process involving the whole organization, but larger institutions may want to establish a separate, independent risk management function.

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. As a director, you 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 your institution to thrive and serve its members. Your integrity must be unimpeachable and your dedication to the job unfailing.

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.

As the regulator of the System, FCA stands ready to help you understand and perform your duties. We welcome your comments and questions.





Appendix A: Financial condition and key financial ratios

To fulfill your fiduciary duties, you should have an in-depth understanding of your institution's financial condition and risk position. You can acquire this understanding by reviewing regular reports showing your institution's financial performance. These reports can help you do the following:

- Assess your institution's financial condition
- Determine whether the risk taken by your institution is consistent with the board's philosophy
- Identify potential warning signs in current operations

Financial reports should present information regarding current operations and financial trends in the areas of credit risk, earnings, liquidity risk, and interest rate risk. They should periodically discuss financial results with regard to the goals and objectives of your institution's budget and business plan. They should also periodically include comparisons with the financial reports of peer institutions. If the financial reports indicate that the institution is failing to meet a budget or business planning goal or if there is a significant difference between the financial reports of your institution and the reports of its peers, management should explain. For financial information to be useful, it must be accurate, timely, concise, and presented in an easily understood format.

FCA provides two reports that you may find particularly helpful: The Uniform Performance Report (UPR) and the Uniform Peer Performance Report (UPPR). As described on pages 8 and 9 of this booklet, these reports are based on the Call Report data that your 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. For more information, read the report descriptions on the FCS Call Reports page on the FCA website.

There are two levels of access to the UPR and the UPPR — a private one and a public one. Your institution has a password that allows access to the private versions of your institution's UPR and UPPR.

You may wish to require management to periodically provide you with your institution's private version of the UPR and UPPR. Because individual financial ratios can be calculated using various methodologies, the ratios presented in the UPR and the

UPPR could differ from the ratios that your institution's management provides to the board. You should ask management to explain any significant differences.

In addition to the UPR and the UPPR, the Six-Quarter Trend Report and the Six-Year Trend Report may also be useful. These reports are similar to the UPR and the UPPR but provide different time perspectives (six quarters or six years of data and ratios) to help you evaluate trends in the various ratios over an extended period.

FCA's Examination Manual section EM-1.3, "Financial Institution Rating System," discusses how FCA assigns ratings to individual institutions. The ratings include the component ratings for capital, assets, management, earnings, liquidity, and sensitivity (CAMELS), and a composite rating. The FIRS Guide, which is included in EM-1.3, provides more specific information about ratings, including the characteristics of each rating and the financial ratio benchmarks that our examiners use when assigning the composite and component ratings.

Financial ratios (whether those internal to your 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 that boards use to monitor their institutions. Most of the ratios noted in this appendix are included in the UPR and the UPPR, and many are used in the FIRS Guide.

Capital

As a director, you are responsible for ensuring that your institution has sufficient capital to accomplish its mission, goals, and objectives. Capital provides a cushion to absorb losses, provides assurance to investors and stockholders regarding your institution's stability and viability, supports asset growth, and contributes to your institution's earnings base.

You should understand both the quantity and quality of your institution's capital. Primary components of the capital base should be stable and readily available to absorb losses. You should also understand and monitor the primary risk exposures to capital — most notably credit risk — and be ready to adjust capital strategies as necessary. Finally, you should understand the relationship between asset growth and capital accumulation (the "sustainable growth rate") and any related management strategies to maintain capital levels. For further discussion of capital adequacy, see section EM-11.1 of our Examination Manual.

Capital planning is critical to ensuring safe and sound operations and viability. FCA regulations require your institution's board of directors to establish, adopt, and maintain formal written capital adequacy plans as part of its financial plans. Capital planning considers events and circumstances that may place demands on your institution's resources and develops strategies to meet these demands. Capital planning begins with an internal assessment of capital needs. This internal assessment includes stress testing. The results of the assessment will then help your board establish capital goals for your institution.

Capital adequacy goals

Your board is required to set capital adequacy goals — or “key capital measures” — for each of the measures defined in FCA regulation part 628, subpart B. These goals should ensure capital is sufficient for the following:

- Protecting against adversity
- Surviving unexpected losses
- Providing for the institution’s continued financial viability
- Providing for the growth necessary to meet the needs of borrowers

While regulations define minimum capital ratios and related conservation buffers, the minimum standards specified by the regulations are not meant to be adopted as the optimal capital goals in your institution’s capital adequacy plan.

Determining capital needs

Your board of directors is charged with establishing these capital goals on the basis of your institution’s particular circumstances and risk profile. The board should assess your institution’s capital needs at least annually, taking into account the operating environment, portfolio risk, growth prospects, and other risks facing your institution.

Stress testing is an essential element in capital adequacy planning. It helps establish and support the board’s risk appetite, define limits, adjust strategies, and develop action plans for various scenarios. You and your fellow board members must carefully monitor capital levels at your institution and hold management accountable for achieving the established capital goals. Management reporting should be sufficient to allow the board to monitor and understand key trends and issues related to capital and facilitate effective capital management decisions.

Capital distribution programs

Your board is also responsible for governing your institution’s capital distribution programs. Capital distributions, which are subject to FCA regulatory prior-approval requirements, can significantly affect an institution’s overall capitalization. For this reason, you should never put decisions to declare capital distributions on automatic pilot. These decisions should be based on sufficient due diligence, and capital distributions should be readily adjusted when needed to achieve capital goals and adhere to regulatory requirements.

In addition, your board should carefully manage member expectations to ensure capital distributions can be adjusted without significant reputation risk. For example, any advertisement of capital distributions as part of marketing messages should clearly disclose that distributions may vary based on changes in financial performance, capital requirements, asset growth, emerging risks, and other issues. More frequent patronage declarations, such as those made on a quarterly or semi-annual basis, may also make it more difficult to manage member expectations and

reputation risk when adjusting distributions in response to evolving conditions. Patronage should typically be declared annually when financial and capital plans are updated.

Regulations require your capital plan to do the following:

- Address projected patronage payments and other actions that may decrease capital
- Identify the minimum timeframe within which certain equities may be redeemed and paid to borrowers

We encourage you to review section EM-11.2 of our Examination Manual for further discussion of capital management.

Key capital ratios/measurements

Regulatory capital ratios: FCA's regulatory capital regime is largely consistent with the Basel III capital standards applied by other federal bank regulators except where the standards have been modified to accommodate the System's cooperative structure. FCA has defined and set minimum regulatory levels for the following ratios:

- Common equity tier 1 capital ratio (CET1) (4.5%)
- Tier 1 capital ratio (6.0%)
- Total regulatory capital ratio (8.0%)
- Permanent capital ratio (7%)
- Tier 1 leverage ratio (4%, of which at least 1.5% must be composed of unallocated retained earnings and certain equities that are considered to be unallocated retained earnings equivalents)

Capital ratios provide insight into the composition of capital, the financial strength of the institution, and the ability to fund future growth.

The definitions of these ratios are discussed in the FCA regulations. The first four ratios generally express various components of capital as a percentage of risk-adjusted assets. CET1 is composed of the highest-quality capital components (e.g., unallocated retained earnings) — elements with the greatest staying power when institutions encounter financial trouble.

The tier 1 leverage ratio is a measure of financial leverage. Unlike the other ratios, the asset values in this ratio are not risk adjusted. This ratio is designed to constrain the buildup of leverage in the System and serves as a capital floor to ensure that a minimum amount of capital is held by all institutions, regardless of risk. At least 1.5% of the tier 1 leverage regulatory minimum of 4% must consist of unallocated retained earnings and certain equities that are considered to be unallocated retained earnings equivalents as defined in the regulations. This requirement ensures that capital includes more than just shareholder equities and external capital; it also ensures that there is a cushion of retained earnings to protect your members' investments from loss.

FCA regulations also establish specified conservation buffers to be held above the defined regulatory minimums for each of these measures. If capital levels fall below the defined conservation buffers, the regulations impose limits on the patronage and certain management bonuses that can be paid.

Adverse assets to total regulatory capital: This measure compares adverse assets and other property owned to the institution's total regulatory capital ratio, which includes the adjusted allowance for credit losses. 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 that capital levels may not be adequate include the following:

- The capital position is either declining or is below the board's optimal capital goal or below the capital levels approved in the business plan.
- Asset growth exceeds the institution's capital growth.
- Criticized, adverse, and nonaccrual assets are increasing, indicating that portfolio risk is growing.
- Capital ratios are significantly below average capital ratios for peer institutions.
- Capital levels are approaching the institution's minimum regulatory capital requirements or conservation buffers.

Earnings

An adequate and reliable earnings stream is fundamental to maintaining a safe and sound institution. Earnings represent your institution's first line of defense against capital depletion due to credit losses, interest rate risk, and other risks. The viability of an institution often depends on its ability to earn an appropriate return on its assets and capital. Institutions with good earnings performance can grow, remain competitive, augment capital, and provide a return to shareholders through patronage distributions.

As with capital, earnings should be understood in terms of both quantity and quality. High-quality sources of earnings are stable, recurring, sustainable over the long-term, controllable, and central to the institution's principal business and mission. Interest income on loans is an example of a high-quality earnings source. Earnings should not be contingent on unusual, infrequent, or uncontrollable sources of revenue.

Your board's philosophy on earnings should be clearly documented in your institution's business and capital plans. Earnings philosophies and related strategies should address the composition of income, reflect the competitive environment, and address the need to generate an acceptable return on assets.

System institutions generate most of their earnings from loans, so strategies for loan pricing and structure play a fundamental role in earnings performance. A

philosophy of maximizing interest rate spreads within competitive constraints, and then returning patronage refunds to members at year-end after capital needs have been satisfied, is typically consistent with a sound earn-it-first philosophy. Such a philosophy facilitates strong earnings performance, promotes the institution's capacity to withstand adversity, provides more flexibility to manage capital, and is viewed favorably by external parties, particularly rating agencies and investors.

Clearly, earnings are directly related to pricing. FCA regulations require your board to take an active role in establishing your institution's pricing strategies. Your board should establish pricing policies and set interest rates either on a case-by-case basis or through a board-established interest rate plan within which management must operate. The board and management should ensure the loan pricing program aligns with overall strategic business objectives and initiatives.

Your oversight of earnings should focus on the quantity, quality, and trend of earnings. Reductions in the quantity and quality of earnings are frequently related to excessive or inadequately managed credit risk or interest rate risk, inadequate loan pricing, or high operating costs. Keeping expenses under control contributes to the quality and durability of earnings. Profitability typically declines when expenses grow faster than sustainable revenue.

Potential warning signs that earnings are weakening include the following:

- Budgeted amounts on income and expense items vary considerably.
- Return on assets, return on equity, or net interest margins are significantly different from prior periods.
- Earnings performance is inconsistent or unstable.
- Net interest income or net interest margin is declining.
- Key earnings ratios compare unfavorably with those of the peer group.
- Your institution is relying increasingly on earnings from low-quality sources or from sources that are not central to the institution's principal business.
- Return on equity is significantly lower than asset growth, which indicates earnings are insufficient to capitalize growth even when all earnings are retained.

Management should provide reports to the board showing earnings trends and their key drivers; these reports should also describe performance relative to established plans and budgets.

Key earnings ratios/measurements

Return on average assets: Either net income for the preceding 12 months or year-to-date net income (annualized) divided by average total assets for the period. This ratio measures how efficiently the institution uses its assets to generate earnings.

Net interest margin: Either net interest income for the preceding 12 months or annualized net interest income (interest income less interest expense) divided by average interest-earning assets for the period. This margin reflects funding costs, loan pricing, and investment practices.

Efficiency ratio: Total noninterest expenses for the preceding 12 months divided by the sum of the net interest income and noninterest income (noninterest income includes patronage income received) for the preceding 12 months. This ratio shows how many cents of overhead are spent to generate \$1 of revenue.

Operating expenses to average loan items: Total operating expenses divided by average gross loans. This ratio measures operating efficiency in terms of the relationship between operating costs and loan assets.

Return on average equity: Year-to-date net income divided by average equity capital (net worth). This ratio shows the return on the stockholder's investment.

Liquidity

Liquidity represents the ability of an institution to fund assets and meet obligations as they come due without incurring unacceptable losses or adversely affecting the institution's daily operations and financial condition. Liquidity is critical to the ongoing viability of any business, and maintaining liquidity is one of management's key responsibilities at a financial institution. Sufficient liquidity is essential to provide for expected and unexpected balance sheet fluctuations and to provide for contingencies.

Potential warning signs that liquidity risk is increasing include the following:

- Real or perceived negative developments, which affect market perceptions of System or institution creditworthiness, have occurred in either the internal or external operating environment.
- Declines in asset quality have eroded the borrowing base margins of individual associations and adversely affected scores of district contractual interbank performance agreements (CIPAs).
- Financial performance or projections have declined, posing risk to covenant compliance with general financing agreements for associations or to CIPA scores and market access for banks.
- Rating agencies have downgraded, or announced that they may downgrade, the credit rating of the System or one of its institutions.
- Bank days-of-liquidity measures are approaching the regulatory minimum.
- The spread widens between the interest rates on System debt issuances and rates on comparable issuances from the Treasury or other government-sponsored enterprises.

Your board of directors should maintain policies and strategies for the management of liquidity, a liquidity crisis, or unanticipated funding events.

The System's primary source of liquidity is its access to debt capital markets. FCS banks obtain funding for supporting their associations and liquidity from bonds sold to investors through the Federal Farm Credit Banks Funding Corporation (Funding Corporation). All four banks are jointly and severally liable on bonds issued through

the Funding Corporation and have implemented a market access agreement to promote fiscal responsibility and prudent management throughout the System.

FCS banks also maintain secondary sources of liquidity by holding an inventory of high-quality, liquid investments managed in accordance with FCA regulations. Other sources of liquidity may include lines of credit from commercial lenders. While these lines of credit can provide an alternative source of liquidity in normal periods, they can become expensive or quickly dissipate in an adverse operating environment.

All System institutions, including associations, have a responsibility to maintain strong financial operations. Maintaining strong operations helps protect unfettered access to the debt markets and maintain the market's perception of System creditworthiness.

Because the main source of liquidity for an association is its funding bank, an association's board must ensure its institution complies with the general financing agreement it holds with its funding bank. Failure to comply with the terms of the agreement could result in increased interest costs, fees, penalties, or restriction of funding. Each of these consequences could affect profitability and increase the association's cost of borrowing and, ultimately, the credit cost to borrowers.

Banks and associations use very different principles of liquidity management. Bank liquidity needs are largely driven by liquidity demands at its affiliated associations. Therefore, a bank should seek to maintain sufficient cash flow to fund operations, service debts, meet commitments to fund direct loans to associations and loans to other borrowers, and provide for funding contingencies.

Key liquidity ratios/measurements

Days of liquidity: The number of days of maturing obligations that could be funded by liquid investments at any given point. FCA 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.

Contractual interbank performance agreement score: A score that measures a district's performance and risk. The CIPA is an agreement between all FCS banks and the Funding Corporation. The agreement defines the methodology for calculating the score and establishes minimum score requirements. The CIPA score incorporates measurements of capital, asset quality, earnings, liquidity, and interest rate risk sensitivity. The financial condition and performance of the bank and all district associations factor into each district's CIPA score.

Quality of assets supporting the direct loan: A measurement of the quality of assets that support the direct loan from the funding bank. This measurement, which applies only to associations, measures the amount of high-quality assets available to secure the direct loan with the institution's funding bank. Additional measures of the quality of assets supporting an association's direct loan include loans graded "acceptable" and "special mention" as a percentage of the direct loan, as well as accrual assets as a percentage of the direct loan.

Sensitivity to interest rate risk

Sensitivity to interest rate risk (IRR) refers to the risk that interest rate changes could adversely impact an institution's earnings and capital. IRR is an inherent risk for financial institutions, and it can become excessive if mismanaged. The institution's IRR management program comprises the policies, procedures, and systems used to identify, measure, and manage this risk. The institution's risk appetite, in combination with the effectiveness of the IRR management program, determines whether the level of exposure poses safety and soundness concerns.

IRR management differs between FCS banks and direct-lender associations. FCA regulations establish baseline expectations for IRR management programs at FCS banks and extend these requirements to any System institution with IRR that could lead to significant declines in net income or the market value of capital.

Districts have centralized most asset-liability management functions at the funding bank and use transfer pricing to insulate associations from most IRR sources. Nonetheless, some districts allow greater flexibility in association funding strategies, which can expose them to greater IRR.

Although senior management is responsible for day-to-day management of IRR, board directors at all System institutions should understand the sources and nature of IRR at their institutions. Your board should establish IRR policies and ensure procedures are in place for appropriate asset-liability management practices that reduce exposure to excessive levels of IRR. Your board should also provide oversight to ensure that management effectively identifies, measures, monitors, and controls IRR.

Your institution's IRR management processes should be commensurate with the risks managed, and your board policy should establish explicit limits on the institution's IRR exposure. Your board policy should also provide guidance for the measurement and management of IRR. The FCA booklet "Interest Rate Risk Management" (BL-072) provides guidance on establishing an effective IRR management framework and how it differs depending on IRR exposures.

Potential warning signs that your institution is overly sensitive to market risk or that IRR management is insufficient include the following:

- Net interest income shows significant volatility in response to market interest rate movements.
- Management is not operating within the board's established limits for IRR exposure.
- The amount of, and trend in, IRR exposure is increasing.
- Your institution has a high or increasing volume of assets with unhedged embedded options. For example, fully prepayable fixed-rate loans or investments may pose a risk to earnings and equity when not hedged with callable funding or matched with transfer rates.
- Management reports fail to identify and quantify the major sources of IRR in a clear and timely manner.
- Your institution does not have an independent review or audit of the IRR management process.

Key sensitivity ratios/measurements

Simulations of net interest income and market value of equity: Income simulation is used to forecast how net interest income changes in response to changes in interest rates. Simulations of the market value of equity show possible changes in the market value of assets, liabilities, and off-balance-sheet items as a result of interest rate movements and the impact these changes have on an institution's capital position.

These two simulations show the percentage change in net interest income and market value of equity for a given change in market interest rates. All institutions are required to perform periodic simulations of net interest income. The market value simulation is especially important in large and complex institutions that manage 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.

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. 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 for measuring exposure against those limits.

Duration analysis: Duration is a measurement of the sensitivity of the value of an asset or liability to movements in interest rates. 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.

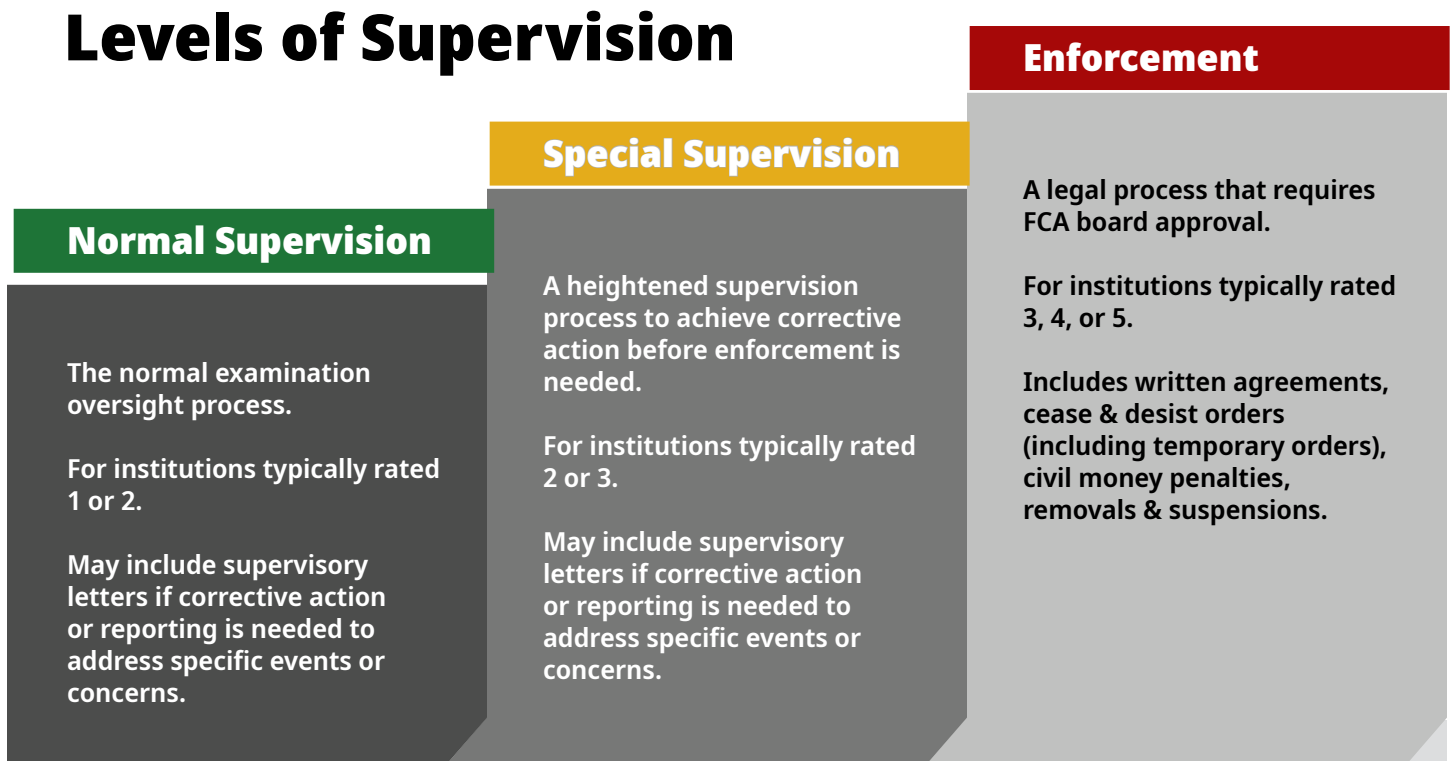




Appendix B: FCA Supervision and Enforcement Authority

We have three levels of supervision: normal, special, and enforcement. The following diagram identifies each level of supervision, listing the actions and documents associated with each level. It also identifies the typical FIRS ratings associated with each level.

As the diagram below shows, the level of supervision we use for your institution generally depends on your institution's FIRS rating and its willingness and ability to address the problems identified. As the level of risk and concern increases, our level of supervision increases.



For those institutions exhibiting conditions that are serious but do not necessarily critically impair the safety and soundness of the institution, we increase the level of supervision from normal to special. We generally use special supervision when any of the following conditions exists:

- The risk profile (relationship of risk to financial capacity) of an institution is considered to be weak and deteriorating, but its total condition does not justify a formal enforcement action.
- The condition of the institution or the practices it uses are unsatisfactory; if the unsatisfactory condition or practices are not promptly and sufficiently addressed, we may take formal enforcement action.
- The board and management recognize the weaknesses and concerns that were identified; they are willing and able to correct them; and their proposed actions are likely to resolve the concerns.
- The financial profile (that is, the earnings, liquidity, and quality of collateral in relation to direct loans) is at the lower end of the satisfactory range and is threatened by increasing risk in the loan or investment portfolios.

As part of the special supervision process, we will typically issue a supervisory letter to the institution's board that identifies specific required corrective actions. We give the institution an opportunity to correct the problems to avoid the need for a formal enforcement action.

If conditions deteriorate, we may take formal enforcement action to establish managerial discipline and to put in place the controls needed to prevent further deterioration or the failure of the institution. We use enforcement supervision for institutions where a formal enforcement action is needed to correct unsafe or unsound conditions and practices or violations of law and regulations.

Examples of actions that could warrant enforcement supervision are as follows:

- The institution or a representative of the institution is deemed unable or unwilling to address a materially unsafe or unsound condition or practice, or a violation of law or regulation.
- The institution or representative is about to engage in a materially unsafe or unsound practice or is about to commit a willful or material violation of law or regulation that exposes the institution to significant risk.
- The institution or representative fails to comply with an enforcement document or is unwilling or unable to address a violation of a "condition imposed in writing" (see below).

Typically, the enforcement documents specify the steps the institution must take to correct problems described in Reports of Examination and the timeframe within which corrective measures must be taken.

The following sections identify and describe the various forms of supervisory and enforcement actions we may take.

Conditions imposed in writing

As part of approving an institution's application request for some action requiring FCA consent, we may put in place "conditions imposed in writing" to address unsafe or unsound practices or violations of law, rule, or regulation. The most common types of application requests are merger or reorganization requests. In these cases, the conditions imposed in writing are referred to as supervisory conditions of merger or reorganization, and we impose them with the consent of the institution. These conditions are in addition to any "conditions of approval." We can take enforcement actions for an institution's failure to comply with conditions imposed in writing.

Written agreements

An agreement is a contract between the institution or an individual and FCA, which commits the institution or individual to taking the specified actions to correct a problem. We use written agreements when problems are not severe enough to warrant a more stringent action and when the board and management are able and willing to address the agreement's requirements. The agreement is executed by an institution's board of directors (or a specified individual) and an authorized representative of FCA. If an institution or individual fails to comply with an agreement, we may begin cease and desist proceedings.

Directives

The Farm Credit Act provides us with the authority to issue capital directives and directives for restructuring distressed loans. While directives are not considered enforcement documents, they are enforceable in the same manner and to the same extent as an effective and outstanding final cease and desist order.

Cease and desist orders

We issue an order to cease and desist to institutions and individuals when problems are severe. This order may also be used when the institution violates agreements or conditions that were imposed in connection with an application (such as a merger or reorganization application). We may issue an order to cease and desist in the following situations:

- An institution or person has engaged, is engaging, or is about to engage in an unsafe or unsound practice.
- An institution or person has violated, is violating, or is about to violate
 - a law, rule, or regulation;
 - any condition imposed in writing by FCA in connection with the granting of any application or other request by the institution or a representative of the institution; or
 - any written agreement with FCA.

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 practices be stopped, or both.

The FCA board decides whether to issue an order to cease and desist. The party to whom FCA issues this order may obtain review of the order by the appropriate U.S. 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.

We 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

- cause insolvency,
- cause substantial dissipation of assets or earnings,
- seriously weaken the condition of the institution, or
- seriously prejudice the interests of investors or shareholders before 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 or to 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 is issued or until charges are dismissed.

Civil money penalties

A civil money penalty (CMP) action requires an institution or individual to pay a monetary penalty. A CMP can be used alone or in conjunction with other administrative actions. We may assess a CMP against an institution or individual for violation of the Farm Credit Act, FCA regulations, or an order to cease and desist. By law, all CMP amounts are reviewed and adjusted each year.

Before we determine whether to assess a CMP, the offending individual or institution has an opportunity to submit relevant information that addresses the violation. Once we review 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, we can order the offending party to pay the penalty, but the party can seek review of the assessment by the appropriate U.S. Court of Appeals. Funds received under a CMP go to the U.S. Treasury.

Removals, suspensions, and prohibitions

To remove or suspend a director or officer or to prohibit him or her from participating in the conduct of the affairs of an institution, we must determine that the individual violated a law or regulation or an order to cease and desist, or that he or

she engaged in an unsound practice or breached a fiduciary duty. We can take such action if any of the following occurred:

- The institution has suffered or probably will suffer substantial financial loss or other damage.
- The director or officer has received financial gain through a legal violation or unsound practice.
- The interests of the institution's shareholders or investors in System obligations could be seriously affected.
- The legal 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 actions with respect to another business or System institution

- have caused a substantial financial loss or other damage,
- show personal dishonesty or willful or continuing disregard for the entity's safety or soundness, or
- show that the individual is unfit to participate in the conduct of the institution's affairs.

The FCA board decides whether to remove the individual, and a removal order may be reviewed by the appropriate U.S. Court of Appeals. If necessary, we may suspend a director or officer pending completion of a removal proceeding. A suspension may be appealed to the appropriate U.S. District Court. Once in place, a removal or suspension order prohibits the person from participating in any manner in the affairs of the institution.

We can also remove or suspend an individual charged with or convicted of a crime that involved dishonesty or breach of trust and that was punishable by imprisonment for more than one year. We can also prohibit such an individual from further participation in any manner in the conduct of the affairs of the institution after showing 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. A suspension remains in effect until we terminate it or until the criminal charge is finally settled.

Conservatorship/receivership

If the FCA board determines that a situation is serious enough to require a conservator or receiver, the board may appoint, ex parte and without notice, a conservator or receiver. The FCA board is the only entity that may appoint a conservator or receiver.

Note: Supervision and enforcement activities related to Farmer Mac are the sole responsibility of the Office of Secondary Market Oversight.





For questions about this publication, contact:

Office of Congressional and Public Affairs
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090
703-883-4056
info-line@fca.gov
www.fca.gov

