



Farm Credit Administration

# The Director's Role

A Guide to Leading Your  
Institution Effectively



*for the Directors of  
Farm Credit System Institutions*

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## Preface

*Throughout this document, “we” refers to the Farm Credit Administration (FCA), and “you” refers to a director of a Farm Credit System (FCS or System) bank or association board. Although the guidance was developed primarily for the directors on the boards of System banks and associations, much of it will also apply 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 Farm Credit 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 with it 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. This booklet does not address all issues that may arise during your tenure as director, however; and it is not intended to be a substitute for legal counsel. You should seek counsel from an attorney or another qualified advisor to address specific circumstances.

We would like to acknowledge the importance of the following publications in producing this booklet:

- The Director’s Book—The Role of a National Bank Director, published by the Office of the Comptroller of the Currency
- Director Liability in Agricultural Cooperatives, published by the Agricultural Cooperative Service, U.S. Department of Agriculture
- Director’s Responsibilities Guide, published by the Office of Thrift Supervision

If you have any questions regarding the content of this booklet, please contact us at the following address:

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Additional information about FCA and the FCS is available on our website at [www.fca.gov](http://www.fca.gov).

Your bank or association is part of a nationwide network of financial institutions known as the Farm Credit System (FCS or System). All of the financial institutions that compose the FCS are federally chartered entities.

Farm Credit System institutions are responsible for carrying out the mandates of the Farm Credit Act of 1971, as amended. The Farm Credit Act provides for a farmer-owned cooperative credit system that extends credit and related services to agricultural producers and other eligible borrowers.

Congress set up the Farm Credit System in 1916 as a cooperative because it wanted to ensure that the System could fulfill its public mission of providing long-term and affordable credit services to agriculture and rural America.

A cooperative structure allows farmer-borrowers to own and control the System and keeps the System committed to serving rural credit needs. This is an important feature that sets the System apart from most other commercial lenders.

The Farm Credit 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—those who buy the goods or use the services of the cooperative. The members participate in setting policies and making decisions.
- **Members' Economic Participation.** Members contribute equally to, and democratically control, the capital of the cooperative. This benefits members according to the amount of business they conduct with the cooperative rather than the amount of money they invest in it.

# Introduction: The Farm Credit System, FCA, and the FCSIC

## The Farm Credit System

- **Autonomy and Independence.** Cooperatives are autonomous, self-help organizations controlled by their members. If a co-op enters into agreements with other organizations or raises capital from external sources, it does so based on terms that ensure democratic control by its members and the autonomy of the cooperative.
- **Education, Training, and Information.** Cooperatives provide education and training for members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives. Members also inform the general public about the nature and benefits of cooperatives.
- **Cooperation among Cooperatives.** Cooperatives serve their members most effectively and strengthen the cooperative movement 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 2005, the Farm Credit Administration conducted a study to identify and better understand the range of cooperative practices employed by System institutions. The study found that, like most other cooperative organizations, FCS institutions generally adhere to three core cooperative principles: user-ownership, user-control, and user-benefits. These principles are the underlying foundation for the System's cooperative practices.

On October 14, 2010, the FCA Board adopted a resolution reaffirming its support for, and commitment to, these core principles as part of the cooperative business model of the System and fulfillment of its public policy mission.

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 is responsible for ensuring that the System remains a dependable source of credit for agriculture and rural America. We fulfill this responsibility by

- developing policies and regulations to help ensure the safety and soundness of System institutions and
- examining institutions to ensure that they operate in a safe and sound manner and comply with applicable law 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 and a field office are located in McLean, Virginia, and we also have field offices in Denver, Colorado; Dallas, Texas; Bloomington, Minnesota; and Sacramento, California.

### *FCA Regulations*

FCA's goal is to provide a flexible regulatory environment that enables 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. To read the full text of the Farm Credit Act and other statutes that apply to the System, go to our website at [www.fca.gov](http://www.fca.gov) and click on the Law and Regulations tab. You will also find the full text of our regulations under this tab.

Periodically we make new regulations, and we publish pending regulations 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. If so, go to [www.fca.gov/law/public\\_comment.html](http://www.fca.gov/law/public_comment.html) and follow the instructions for submitting a comment. We welcome 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 the news releases that we issue after the monthly meetings of the FCA Board, which are generally held on the second Thursday of every month.

After we e-mail the news release to the board and management of each System institution, we publish it under the News and Events tab on our website at [www.fca.gov](http://www.fca.gov). For some proposed regulatory actions, we also issue fact sheets along with the news releases. These fact sheets are available on the Rulemaking Fact Sheets page under the News and Events tab on our website.

### *Guidance Provided by FCA*

In addition to issuing regulations, FCA also issues guidance to System institutions in the following forms. These documents are distributed by e-mail to the boards and management of System institutions and then posted on our website.

- **Policy Statements.** Board policy statements express the broad policy goals and positions of the FCA Board.
- **Bookletters.** Bookletters communicate our positions on specific issues.
- **Informational Memorandums.** Info Memos are informal FCA communications addressed to all FCS institutions.

### *Examination*

At least once every 18 months, FCA examines your institution to ensure that

- it is operating safely and soundly,
- it is complying with applicable laws and regulations, and
- it continues to fulfill its congressionally mandated mission.

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 of directors and management to direct operations. Our examiners also evaluate your institution's compliance with laws and regulations to serve 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 may use our supervisory and enforcement authorities to ensure appropriate corrective action.

As part of every examination, we prepare a Report of Examination to present to your institution's board of directors. The report is first presented to the institution in writing and later presented orally to the board and management.

### **Reports**

FCA generates two types of reports that you may find helpful, and we publish them both on our website. The first type of report is financial, and the second relates to the System's young, beginning, and small (YBS) farmer lending activity.

These reports, which are based on data provided to us by System institutions, will allow you to compare your own institution's financial and YBS performance with that of other institutions. To find the reports described in this section, go to the FCA website and click on Consolidated Reporting System Reports under the FCS Information tab.

- **Financial.** Like all other institutions of the Farm Credit System, your institution submits financial data to FCA every quarter through the Uniform Call Report. Almost all of the data submitted through the Uniform Call Report are available to the public through the FCA website.

In addition, FCA develops the following reports from the data provided in the Uniform Call Reports:

- **Uniform Performance Report.** This report provides a condensed balance sheet and income statement for each institution, as well as additional information on the institution's capital, assets, earnings, profitability, and liquidity. Four reporting periods are represented—the current quarter, the same quarter 12 months earlier, and the past two 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 by selecting up to six institutions to compare. In addition, you may generate reports by district, as well as Systemwide reports according to the 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.** Each institution submits its YBS report annually. This report presents the institution's outstanding lending activity in the young, beginning, and small borrower categories.

You may view YBS data 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*

Following are several other resources you may find helpful while serving as a director. Most of these resources are available on the Resources for the FCS page, located under the FCS Information tab on the FCA website. If you do not have access to the Internet, you may call 703-883-4056 to request paper copies of these resources.

- **Frequently Asked Questions.** FAQs have been issued on many regulatory topics, including System governance, disclosure and reporting, collateral evaluations, borrower rights, and stress testing.
- **Loan Portfolio Management.** This document outlines the methods of controlling risk in individual loans and loan portfolios and explains interrelationships between the planning, directing, controlling, and monitoring of lending operations.
- **FCA Exam Manual.** The Exam Manual contains concepts, guidelines, and procedures for the examination of Farm Credit System banks, associations, and service corporations.
- **The Role of Farm Credit System Nominating Committees.** This brochure describes the responsibilities of bank and association nominating committees in the director nomination process.
- **FCA Annual Reports on the Farm Credit System.** These reports provide information on the financial condition and performance of the FCS as a whole. To find these reports, look under the Reports and Publications tab on the FCA website.

## 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 Government-controlled corporation established by the Agricultural Credit Act of 1987. Congress created FCSIC in the wake of the agricultural credit crisis of the 1980s to renew investor faith in the financial integrity of the System.

FCSIC insures the timely payment of principal and interest on Systemwide notes, bonds, and obligations issued to investors. It does this by collecting insurance premiums from FCS banks and placing those premiums in the Farm Credit Insurance Fund, which it administers.

Calculated using a statutorily defined formula, premium rates are generally based on each bank's pro rata share of insured debt. FCSIC may collect from 0 to 20 basis points annually on adjusted insured debt outstanding. The Farm Credit Act of 1971 also authorizes a risk surcharge of up to 10 basis points on nonaccrual loans and on other-than-temporarily impaired investments. FCSIC also has the authority to reduce insurance premiums.

Congress directed FCSIC to build the Farm Credit Insurance Fund to a "secure base amount." The secure base amount is defined as 2 percent of the aggregate of the outstanding insured obligations of all insured banks, adjusted downward by certain percentages of the System's Government-guaranteed loans and investments. For current information about the Fund's secure base amount and insurance premium rates, go to the FCSIC website at [www.fcsic.gov](http://www.fcsic.gov) or contact FCSIC by phone at 703-883-4380.

In addition to building and maintaining the Fund, FCSIC has other mandatory and discretionary responsibilities. For example, FCSIC has the authority to decide whether and how to provide assistance to FCS banks and direct-lender associations in financial difficulty, subject to certain limits. The ways it may provide assistance include

- providing loans or contributions,
- purchasing assets and debt securities,
- assuming liabilities, and
- 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. At year-end 2010, eligible borrower stock outstanding at FCS institutions totaled \$6 million.

FCSIC is administered by a board of directors made up of the individuals who serve as members of the Farm Credit Administration Board. The chairperson of the FCSIC board of directors is elected by the other directors and may not serve concurrently as chairperson of the FCA Board.

The Farm Credit Act requires each System bank and association to elect from among its voting members a board of directors. The board of a System institution, like that of any other corporate organization, is elected to oversee the management of the institution.

Your institution is to follow its own bylaws and FCA rules with regard to

- the number of directors on the board,
- the length of the directors' terms,
- the qualifications director-candidates must meet, and
- the manner in which directors are to be elected and removed.

Your board's size should be large enough to provide adequate stockholder representation and to ensure that it has the collective skill set needed to address the challenges the institution faces, both current and projected. It must also be small enough to get meaningful input from each director and to avoid developing the "rubber stamp" mentality frequently associated with larger boards.

Although the board of a System institution is mostly composed of stockholder-elected directors, the law requires at least one member to be an "outside director." An outside director is appointed by the other board members and may not be a director, officer, employee, agent, or stockholder of any System institution.

Outside directors are valuable because they provide an independent and objective perspective to the board's deliberations. They also provide the board with valuable technical expertise.

Regulations governing System banks and associations generally require that they have at least two outside directors. Associations with \$500 million or less in total assets are only required to have one outside director.

While the board is not prohibited from adding more outside directors, under no circumstances should stockholder-elected board representation drop to less than 60 percent. If a larger association's board size is so small that the addition of a second outside director would result in less than 75 percent stockholder-elected representation on the board, it is exempted from the requirement to have a second outside director.

## The Board of Directors: Its Structure and Composition

### Outside Directors

## 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. The financial advisor 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 who is 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 that are similar to those 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 the FCA website. To access the link to the decision tree, go to the Governance of FCS Institutions page under the FCS Info tab at the top of the FCA homepage.

## Committees

Matters that require detailed review or analysis may best be addressed by a committee of the board rather than by the full board. Think of a board committee as an extension of the board. The purpose of the committee is to assist the board in carrying out its fiduciary duties.

Your institution's board is required to form two types of committees:

- Audit Committee
- Compensation Committee

Your institution also is required to have a nominating committee. However, the Nominating Committee is a stockholder committee—not a board 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 Management Committee.

Your board should follow the guidelines below with regard to both mandatory and optional committees.

- When creating a committee, draft a charter defining the committee's mission, authorities, responsibilities, and duration. Standing committees address continuing areas of responsibility, while ad hoc committees may be set up to handle special projects—for example, mergers or joint management agreements.
- Ensure that the committee receives the support and resources it needs to carry out its duties.
- Identify the technical knowledge and experience the members of the committee should have to effectively address the issues before the committee.
- For committees requiring specialized skills or knowledge, ensure that committee members receive any necessary training or have access to third-party experts.
- Require regular reports from the committee to ensure that your board can make decisions in a timely manner.
- If a board decision is made on the basis of a committee recommendation, be sure the committee has done its work responsibly and that its recommendations are reasonable. Establishing a committee to handle certain matters does not normally relieve your board of any accountability for decisions related to these matters.

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 purpose of the audit committee is to serve as the guardian of your institution's financial integrity.

Because the committee acts on behalf of the board in carrying out its fiduciary responsibilities to stockholders, audit committee members should be well-qualified board members who operate independent of management. This committee reports only to your board.

The audit committee has the following responsibilities:

- To oversee the preparation of financial reports
- To hire, and oversee the work of, the external auditor, ensuring that the auditor objectively assesses your institution's financial reporting practices and minimizing undue management influence in the review of financial reports and accounting procedures
- To oversee your institution's system of internal controls relating to financial reports
- 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 committee meetings

There are a few general requirements regarding the composition of the audit committee.

- The committee must be composed solely of directors.
- It 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 instead satisfy this requirement by retaining an advisor who is a financial expert. If your institution retains an independent financial advisor, this advisor must assist the audit committee.
- The committee must consist of at least three directors with 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. For those directors who, upon election or appointment to the board, might not have sufficient financial knowledge to serve on an audit committee, your institution should provide a training program in appropriate financial areas.

### *Compensation Committee*

The purpose of the compensation committee is to ensure that compensation policies and procedures encourage improved or continued performance, while not jeopardizing key business and capital plan goals and objectives. Your institution's compensation policies

should address not only the salaries provided to senior officers and employees but other benefits as well. See page 36 for more information about compensation.

The compensation committee has the following 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.

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.

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

### *Nominating Committee*

The nominating committee is not a committee of the board; rather, it is formed and controlled by the voting stockholders of the institution. In this regard, System institutions differ from many public companies and other corporate entities, where nominating committees are board committees and composed of directors and managers of the company.

The nominating committee's independence is critical to the success of a cooperative institution because it ensures that representatives of the voting stockholders, not the current board members or the institution's management, choose the slate of director-candidates. Directors, employees, and agents may not be present when the committee deliberates and votes on its slate of candidates.

The nominating committee has the following responsibilities:

- The nominating committee must identify, evaluate the qualifications of, and nominate at least two willing and qualified candidates for each open director position.
- If the nominating committee is unable to identify more than one willing and qualified candidate for an open director position, the committee must provide in writing a description of its efforts to locate other candidates and an explanation as to why these candidates were disqualified from consideration.

Your institution's nominating committee must be composed of at least three stockholders who are independent of the institution's board, management, and staff.

Requirements regarding the election of nominating committee members differ somewhat for banks and for associations. Association nominating committees are elected by the voting stockholders each year at the annual meeting to serve the following year. Banks, on the other hand, do not have to elect the nominating committee at the annual meeting, and their committee members are not limited to one-year terms.

The following guidelines apply to nominating committees:

- Every nominating committee should meet regularly throughout the year to identify qualified candidates, rather than waiting until the month before the election.
- The nominating committee should keep records of its meetings.
- The nominating committee should make every effort to ensure that nominees represent all areas of the institution's territory and, as nearly as possible, all types of agriculture practiced within the territory.
- The committee should nominate candidates that will give the resulting board a combined skill set that enables the board to address the issues it faces and expects to face.

As a member of a board of directors, you owe fiduciary duties to your institution, and you must exercise reasonable care in governing your institution's activities. However, as a director of a financial institution, you face special challenges because financial institutions differ from private companies in an important aspect—they put the funds of others at risk through their lending activities.

In addition, if you are an elected director, you face an added challenge: You yourself are a borrower of your institution. Therefore, you must be scrupulously objective when you take actions that may affect your interests as a borrower.

So 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 management
- Overseeing all major institution functions

Together, you and your fellow board members are responsible for the safe and sound operation of your institution regardless of economic conditions in local, domestic, and international markets. Your board is accountable to shareholders and investors for the following:

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

The ultimate responsibility for the conduct of your institution's affairs lies with you, your fellow board members, and your institution's management. 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 that the institution operates within prescribed policies, in compliance with laws and regulations, and in a safe and sound manner.

## The Board of Directors: Its Responsibilities and Roles

## The Board's Role in Strategic Direction and Business Planning

The board's effectiveness will depend in part on how well you and your fellow board members know your institution. Your board must have the necessary knowledge and skills to carry out its duties in an efficient, cost-effective manner. Therefore, you must diligently seek to understand the operations of your institution to faithfully execute your duties. 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 have seen considerable change over the past several years, and more changes are anticipated. Generally, these changes create additional risks for institution operations and for institution borrowers. Your board has an obligation to continually reevaluate its collective skill set in light of these changes.

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, your board must 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.

Unprecedented changes in the System and the financial services industry have heightened the importance of effective planning. Planning can be used as a tool to chart progress and to maintain sound operations during periods of uncertainty and change. It 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, 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 will enable the board to identify strategies to achieve its vision. Because effective planning is essential to institutional health, you need to be fully involved in the planning process.

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 can be divided into two components:

- Strategic
- Operational

Strategic planning focuses on the long-term deployment of resources to achieve institutional goals. The strategic plan states the board's overall philosophy and its vision of the institution's future. Operational planning concentrates on short-term actions; it helps institutions achieve long-term goals by translating them into specific, measurable targets.

The purpose of the business plan is to identify those 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 particular 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 its strategies and the use of institution resources will reasonably accomplish the intended purposes.

Your board should use the following guidelines when planning:

- 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 the board to design goals and strategies to best meet the mission of your institution.
- 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 the risks may affect future performance. Also, defining risk helps you make pro-

## The Board's Policymaking Role

jections and determine financial needs to address those risks. Once risks are defined, the board may require management to explore alternative methods for managing your institution's exposure to these risks.

- Establish reporting requirements for each component of the 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.

When making policy, boards should consider the following:

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

Boards may use various approaches to develop policy. In some cases, the entire board may establish broad guidelines for a given policy but then delegate the responsibility of working out the detailed aspects of the policy to a board committee or to management. In other cases, after providing general guidance, the board may entirely delegate to management the task of drafting the procedures to implement a policy.

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.

Typically, the internal auditor evaluates the institution's compliance with board policies, and management evaluates the policies' effectiveness. In some instances, the internal auditor may evaluate both compliance and effectiveness.

In addition, the board should periodically evaluate whether policies are accomplishing their intended objectives and goals. The board might schedule the review of certain policies at board meetings or provide 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.

The board must ensure that policies adequately direct and control the business affairs of the institution at all times. That's why policies should be reevaluated and revised as necessary. The board is also responsible for ensuring that policies are thoroughly understood at all levels of the institution. Your board can accomplish this by creating a policy manual that serves as a single authoritative reference. In addition, training programs can provide a better understanding of more complicated policies and procedures.

An effective policy includes or addresses the following components:

- **Purpose.** A statement of purpose clearly articulates the policy's goals.
- **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.
- **Delegations.** Each policy that requires specific action by committees, officers, or employees of the organization should clearly define which authorities are delegated by the full board and which are retained by the board or by a board committee. For example, the full board might adopt a policy that establishes limits on concentrations of risk in various portfolio segments or limits on loan size in relation to your institution's capital base or risk funds. 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 ap-

## The Board's Oversight Role

proval or review by the board. The board must ensure that delegated and retained authorities are appropriate and that the board is neither abdicating its authority nor unnecessarily restricting the institution's operations.

- **Exceptions to Board Policy.** Unexpected and urgent matters may arise that require 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.
- **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.

While the board and management form a partnership in directing the operations of the institution, the board of directors is still responsible for providing strong oversight of your institution's performance. 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.

In connection with regularly scheduled meetings, you and your fellow board members should plan regular executive sessions without institution officers or staff present. This will facilitate open and candid discussion.

To provide effective oversight, your board must

- evaluate your institution's business and financial performance,
- assess your institution's operational performance and asset quality,
- ensure that your institution accomplishes its mission,
- perform self-evaluations and adhere to ethical principles, and
- maintain a proper relationship with management.

### *Evaluating Business and Financial Performance*

Business and financial performance involves more than the amount earned—it involves 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 do this, you should receive training in all aspects of your institution’s business.

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

- identify and manage risks;
- identify quality assets that can weather adversity;
- maintain well-controlled expenses; and
- 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 with delays in charge-offs or insufficient provisions for loan losses. 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.

Not all directors have enough experience in complex financial matters to be capable of independently evaluating the institution’s financial performance. For this reason, you and your fellow directors have the authority to enlist the help of an independent financial expert. (See “Financial Experts” on page 12.) While you and your fellow board members should be able to discern poor operating performance, you may seek training under the institution’s director training program to enhance or reinforce your financial knowledge and skills.

Although there are no model numbers or ratios 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 long-term indicators?
- Are significant 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 responsible answers are provided. The following guidelines will help:

- Don't wait until problems arise to ask individual key management employees questions regarding your institution's condition and performance. Ask them periodically.
- Attend every board meeting and arrive prepared, having reviewed all available information in advance.
- Ask questions to 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.

- Ensure that you receive sufficient financial information to evaluate your institution's performance. This is particularly important if you are a member of the audit committee.
- Ensure that there is adequate financial expertise on the audit committee to assist the board in the conduct of its fiduciary responsibilities to stockholders.
- Require the audit committee to provide regular reports to the full board. Some of this financial information is represented by key financial ratios and data relating to critical aspects of operational performance.
- Be sure you understand the significance of, and trends in, the financial ratios. Appendix A of this booklet discusses several key financial ratios to help you understand and track your institution's financial performance.

### *Assessing Operational Performance and Asset Quality*

The principal assets of your institution are the loans you make. 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 used by the board and management to plan, direct, organize, and control lending operations. Some of the key components of an effective system include

- strategic portfolio planning,
- lending policies and procedures,
- loan underwriting standards,
- stress testing,
- a reliable risk identification program,
- clearly defined limits for various portfolio concentrations, and
- an internal credit and collateral review program.

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

- Ensure that appropriate lending policies and underwriting standards are in place.
- Ensure that management conducts portfolio stress testing to predict portfolio risks under a variety of conditions.
- Establish clear direction for managing risk concentrations and ensure that processes and controls are in place.
- Closely monitor the findings of the internal credit review and any weaknesses discovered in lending processes and practices. This is particularly important for members of the audit committee.
- 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. For example, asset quality statistics should clearly and concisely show both the institution's current position and its historical trends.

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 the troubles. Sometimes they result from unforeseen circumstances beyond the institution's control.

In any event, it is important for problem credits to receive close attention. A plan of correction or collection should be put in place on each troubled credit. In many instances, your board may wish to approve the individual correction plan and be provided with periodic progress reports. But in all instances, your board should ensure that plans are being put into place and are being followed.

A neglected problem credit is more likely to result in loss than one that is well administered. Although deviations from acceptable asset quality may occur periodically, the board is ultimately accountable for ensuring that lending programs preserve and enhance your institution's capital, regardless of the operating environment.

### *Ensuring Mission Achievement*

One of the board's most important responsibilities is ensuring that the institution accomplishes its mission, goals, and objectives. The mission of the Farm Credit System is clearly 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 board must ensure that your institution has sufficient capital. What constitutes sufficient capital? That depends on the following factors:

- Your institution’s operating environment
- Risks within your institution
- Goals set by the board

The board must carefully monitor all components of capital, both stable and transitory, to keep the institution’s financial foundation sound. Capital goals should not be limited to FCA regulatory requirements; these requirements only prescribe the minimum required of each institution, and most institutions will likely require more capital than the regulatory minimum. The board and management should conduct analysis to determine the amount of capital appropriate for your institution. Most important, capital levels should be reflective of the risks within the institution—existing and anticipated.

The board may adjust capitalization levels by adjusting either the amount of direct borrower investments or the amount of retained earnings. Every year the board must determine whether the institution’s current-year earnings are sufficient to return patronage, and it must carefully evaluate the institution’s earnings performance, capital adequacy, and future business strategies before determining the amount of patronage distribution.

But to fulfill its mission, your institution must do more than provide adequate capital. It must continue to function under cooperative principles. Core cooperative principles include user benefits, user ownership, and user control. The following guidelines will help to ensure that your institution adheres to these cooperative principles:

- Actively seek and encourage stockholder participation in setting the direction for the institution.
- Understand the distinctive cooperative principles and philosophies the institution holds and be aware of their implications, especially as they relate to stock and patronage.
- Be mindful that the System was intended for all types of producers, not just existing stockholder-borrowers.

- Develop plans and policies that will extend the full range of System benefits to all types of eligible borrowers within your institution's territory because the System's cooperative benefits, ownership, and control should be available for all types of producers, including women and minorities. Also, programs for young, beginning, and small farmers are specifically required.

Notwithstanding its cooperative philosophy, the board should ensure that the institution is operating as a profit-oriented business and that it maintains financial stability to serve future generations of borrowers. Short-term problems must not be allowed to affect long-term objectives.

### *Performing Self-Evaluations and Adhering to Ethical Principles*

You and your fellow directors are responsible for evaluating your effectiveness as a board in achieving safe and sound operations and in 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, particularly in light of existing and projected circumstances. Board evaluations are ideally performed in connection with the annual planning and review of your institution and its management.

Finally, to ensure that you and your fellow board members provide proper oversight of your institution, we encourage you to

- develop a code of ethics,
- review the code on a periodic basis,
- distribute the code to all appropriate parties, and
- prominently display and adhere to the code.

Sound ethics, adherence to standards of conduct, 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. Every sound and successful operation is led by a quality management team. That's why the board's duty in hiring and retaining quality management is one of the most critical elements to the institution's success.

At all times, you and your fellow directors must ensure that management is carrying out your institution's mission and goals. Your board must establish and maintain a proper and independent relationship with management. 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 following guidelines will help you and your fellow board members ensure that your institution is properly managed.

- When hiring the CEO, consider each candidate's integrity, education, technical competence, and sound lending and management experience.
- Ensure that management understands the cooperative philosophy and principles upon which your institution is based.
- Provide clear standards of performance and measurable results to ensure that management fully understands the board's performance expectations and that it is accountable for fulfilling those expectations.
- 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
  - ◆ 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, external audit reports, and internal business performance and credit quality indicators

- 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 management for poor performance, dishonesty, conflicts of interest, or other reasons. All such actions should be properly documented in the institution's official records. When such steps are called for, a board's failure to act expeditiously may represent a serious breach of its fiduciary responsibilities.
- Develop a succession policy for the CEO. If no individual in your institution is suitable to succeed the CEO, you and your fellow directors should identify a competent and experienced temporary replacement. One measure of a good CEO is the strength and expertise of the entire senior management team. Review contingency plans annually and include succession planning for the other critical management levels, including, but not limited to, the chief financial officer, the chief credit officer, and the chief information officer.

Your board may delegate management authority to the institution's officers, but be careful: a delegation that is too broad, without appropriate standards, may be considered an abdication of the board's management functions. Delegation of such authority does not relieve you and your fellow board members of your legal responsibilities for the outcome.

Your institution is governed by the Farm Credit Act, and it is subject to other Federal laws and regulations. As a director of a System institution, you may be held personally liable and subject to monetary penalties or other sanctions if you

- engage in unsafe or unsound practices,
- fail to comply with statutory or regulatory mandates, or
- breach a fiduciary duty (or permit another person to do so).

In addition, you can 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.

You may be held responsible either alone or jointly with other board members in lawsuits brought by shareholders/investors and in FCA enforcement actions.

As a director, you are subject not only to Federal law and regulations but also to common law. Unlike statutory law, which is enacted by a legislative body or executive action, common law (also known as case law or precedent) is developed by judges in court decisions. It constitutes generally accepted legal principles. Common law and statutory provisions, including Federal statutes and state corporate and fiduciary statutes, often address the same types of conduct. Therefore, a lawsuit against a director could allege a violation of common law or statutory law. In the exercise of your institution's corporate powers, the common law duties you owe your institution and its stockholders are similar to the fiduciary duties of trustees.

By accepting the position of director, you assume a fiduciary duty to the institution and its stockholders (and, in some instances, to its creditors), and you are therefore liable for damages resulting from any breach of that duty. Your fiduciary duties as a director are typically described as the duties of due care, obedience, and loyalty.

### *Due Care*

The duty of due care requires you to perform your job as a reasonable and prudent person would do in similar circumstances. This means that you must make a reasonable effort to gather and consider relevant information.

# Legal Responsibilities of Directors

## Common Law Liability

What constitutes “reasonable” varies among courts, but when a court examines whether a director has fulfilled the duty of due care, it measures the director’s conduct against that of a hypothetical director of ordinary diligence, possessed of the same information and acting under similar circumstances, not against the conduct of an expert. Courts often will also consider special factors that might affect how the hypothetical director would act.

What would constitute a breach of the due care duty?

- Failing to attend board meetings or not reviewing such essential documents as the quarterly and annual reports
- Failing to maintain adequate audit procedures
- Permitting false statements to be made in reports
- Failing to examine reports (including Reports of Examination) that pointed out problems warranting attention

As a director bound to exercise due care, you must investigate matters of concern and, when you discover an actual or potential problem, you must learn the facts and resolve the situation. Not only must you act in a careful manner, but you must also not neglect to act. For instance, if you learn, whether by informal communication or written report, that an auditor or examiner has raised a concern, you must make sure that the board and management review the matter and take any needed corrective action. You may also be responsible for monitoring the resolution of a problem to ensure it doesn’t recur.

Another responsibility considered part of due care is the hiring and supervision of management. Though not responsible for the day-to-day operations of your institutions, you and your fellow directors are expected to hire competent managers and establish policies and procedures to guide management. You are also expected to evaluate how well management is fulfilling its duties.

### *Obedience*

The duty of obedience requires you to act within the limits of power granted to you by law and regulation and by your institution’s charter, articles of incorporation, and bylaws. To perform this duty faithfully, you must familiarize yourself with the legal constraints under which your institution operates and seek legal counsel when you are uncertain whether a particular action is authorized. You must also keep yourself sufficiently informed about your institution’s activities to properly supervise management.

## *Loyalty*

The duty of loyalty prohibits you from placing your personal or business interests above the interests of your institution. You must deal fairly with your institution, refrain from letting personal interests affect your decisions, and always act honestly and in good faith.

The duty of loyalty does not mean that you may not do business with your institution or participate in transactions in which your institution may have an interest. However, it does mean that you must disclose fully to the board any personal interest you may have in matters affecting your institution, and you must ensure that any transactions involving these interests are evaluated and that decisions are made by disinterested directors.

Follow these four basic rules to fulfill the duty of loyalty:

- **Adhere to standards of fairness.** Having a reputation for honest dealings is important. Having the good opinion of the internal community—the employees and officers—is critical for effective corporate governance. Even more important is to have the good opinion of those outside your institution. You must observe strict standards of fairness in handling your own transactions and those of other member-borrowers. You must never favor some member-borrowers over others who are similarly situated.

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

- **Avoid taking wrongful advantage of corporate opportunity.** You must not take personal advantage of business opportunities that might benefit your institution without first offering those opportunities to your institution.
- **Avoid misusing your position.** You must not use influence or knowledge acquired through your official position for personal gain. You must deal with your institution's assets solely for the benefit of your institution and its member-owners. Institution assets must not be appropriated, given away, or wasted.

## The Business Judgment Rule

- **Disclose conflicts of interest.** When you stand to gain personally from a proposed action or inaction by your institution, a conflict of interest may exist; the legal and regulatory problems that directors encounter often result from such conflicts. When in doubt, you should ask the institution's standards of conduct officer whether an actual or apparent conflict exists and whether you can participate in considering the matter.

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 need not disclose noncash compensation if its annual aggregate value is less than \$5,000.

In addition to disclosing conflicts of interest with your institution, you must refrain from considering or voting on any matter in which you have a conflict and from attempting to influence the vote of others on such matters. To be prudent, you should avoid even the appearance of a conflict of interest by disclosing the apparent conflict to the institution and by refraining from considering or voting on the matter.

The business judgment rule recognizes that, without allowance for honest error, no director could afford to be associated with the position. Because of this rule, courts will not hold you liable for decisions—even if they turn out to be wrong and to bring hardship to the institution—as long as you fully meet the duties of care and diligence.

When applying the business judgment rule, the courts will consider whether your decision-making process involved careful consideration of the reasonably available and relevant facts necessary to making a well-informed decision, and whether you honestly and reasonably believed that the decision was in the best interest of the institution.

Because courts consider the decision-making process when determining liability, documenting your board's decision-making process is important. The courts are less likely to examine the

substance of a decision or the deliberative process the directors followed in reaching their judgment if there is an adequate record of informed decision making.

In most jurisdictions, directors may rely on officers, experts, and business records for facts as long as there is a reasonable basis for such reliance. When you reasonably rely on others, you are protected from liability if you are misled or given incorrect information.

However, you are not protected if you rely on information provided by an officer or expert whom you have reason to doubt. In addition, you should not rely on officers or experts for decisions on matters that you are charged with deciding. When the line between facts and judgment is blurred, which is often the case, you should not unduly rely on the views of others.

As a director, you are not expected to be an insurer or guarantor of your institution's success or of the conduct of its officers. You are also not expected to be all-knowing in your business decisions regarding your institution.

You are expected, however, to carry out your duties in good faith, in the best interest of your institution, with diligence, and with the exercise of unbiased, independent judgment. If you do this, the business judgment rule can protect you from liability.

# Compensation

Your institution must have a compensation program for senior officers and employees. The purpose of the program is to reward success and retain outstanding talent without compromising your institution's safety, soundness, and mission. The compensation program should address not only the salaries provided to senior officers and employees but other benefits as well, including

- perquisites,
- short- and long-term incentives,
- deferred compensation,
- retirement and pension programs,
- supplemental pension programs for senior officers,
- executive employment and severance agreements,
- change-of-control provisions, and
- succession planning and retention bonuses.

Your institution must follow the statutory and regulatory requirements regarding compensation. Our regulations require every bank and association to have a compensation committee. See page 14 for the requirements and responsibilities of the compensation committee. In addition, both the Farm Credit Act and our regulations specifically address the issue of compensation for directors of System banks.

## *Compensation for Bank Directors*

The Farm Credit Act places a limit on bank director compensation. In accordance with the act, we adjust the limit each year to reflect changes in the Consumer Price Index. Generally, we publish an Informational Memorandum in late January or early February with the compensation limit for each new year.

Our regulations provide for a waiver of the statutory limit in exceptional circumstances where the director contributes extraordinary time and effort in the service of the bank. (See FCA regulation 611.400(c).) Circumstances in which exceeding the statutory limit might be warranted could include the following:

- The bank is involved in a merger, consolidation, or other corporate restructuring.
- The bank makes a joint management proposal with another System bank or participates in a joint strategic planning project with another System bank.

Banks must document the circumstances justifying additional compensation, as well as the amount of the additional compensation.

## *Guidelines for Effective Compensation Programs*

- Define your philosophy, objectives, and practices governing compensation and 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.
- Make sure that your institution has sufficient earnings to cover both its compensation program and other costs of operations.
- If your institution provides deferred compensation to officers or employees, be sure to understand the future financial impact of the compensation program and address the impact in the institution's financial planning.
- Do not allow compensation policies and plans to adversely affect the overall goals, objectives, or mission of your institution.
- Pay particular attention to any potential reputation risks that your institution's compensation program might create for your institution.
- Particularly during difficult economic times, be mindful of how your institution's compensation program might be perceived by the public and by Congress.
- Be diligent and prudent in your decisions regarding compensation programs.

# FCA's Examination, Supervision and Enforcement Authorities and Activities

## Examination

Congress requires the Farm Credit Administration to examine all Farm Credit System institutions at least once every 18 months. We fulfill this requirement by conducting a statutory compliance examination, but we may also conduct additional examinations as necessary. An examination is an objective assessment as to whether your institution is operating in a safe and sound manner and in compliance with laws and regulations.

Our examiners, who are located throughout the United States, perform the examinations. They exercise flexibility in choosing examination procedures and the best method to communicate results and expectations for corrective actions. Examiners make their decisions based on their assessments of the nature of the individual institutions, their degree of risk, and the adequacy of their governance and internal control systems.

This risk-based examination approach has resulted in a more effective and efficient examination process. Examiners are able to tailor the interval between examinations to the individual institution's risk profile. Smaller, well-managed, and sound institutions do not require the same amount of examination and oversight as do larger, more complex institutions or those that are troubled. (For information about the types of risk we consider, see Appendix B.)

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 either be included in the examination report or discussed with your board at the board meeting.

The examination report will discuss your institution's condition, operation, and compliance with laws and regulations. It will also identify any corrective actions needed. In addition, interim activity letters are issued throughout the examination period; these letters are also considered to be examination reports and should be treated as such.

Examination reports do not diminish your role as a director in overseeing your institution's operations. Rather, they are tools to assist you in monitoring your institution's safety and soundness and its compliance with laws and regulations. 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 extent and 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 you come to the meeting. In this way, you'll be prepared to ask questions.

Please keep in mind that you may not necessarily agree with all of the examiners' conclusions, but do make sure you understand and fully consider the basis for the conclusions and how failure to address and resolve concerns could affect the safety and soundness of your institution.

Most of the time, your institution's management is invited to take part in the meetings, but each meeting also should provide an opportunity for the board members to meet in executive session with the examiners with no managers present.

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), which is similar to, but somewhat different from, the system used by other financial institution regulators. On a quarterly basis, the examiner evaluates your institution's capital, assets, management, earnings, liquidity, and sensitivity to changes in interest rates (CAMELS).

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

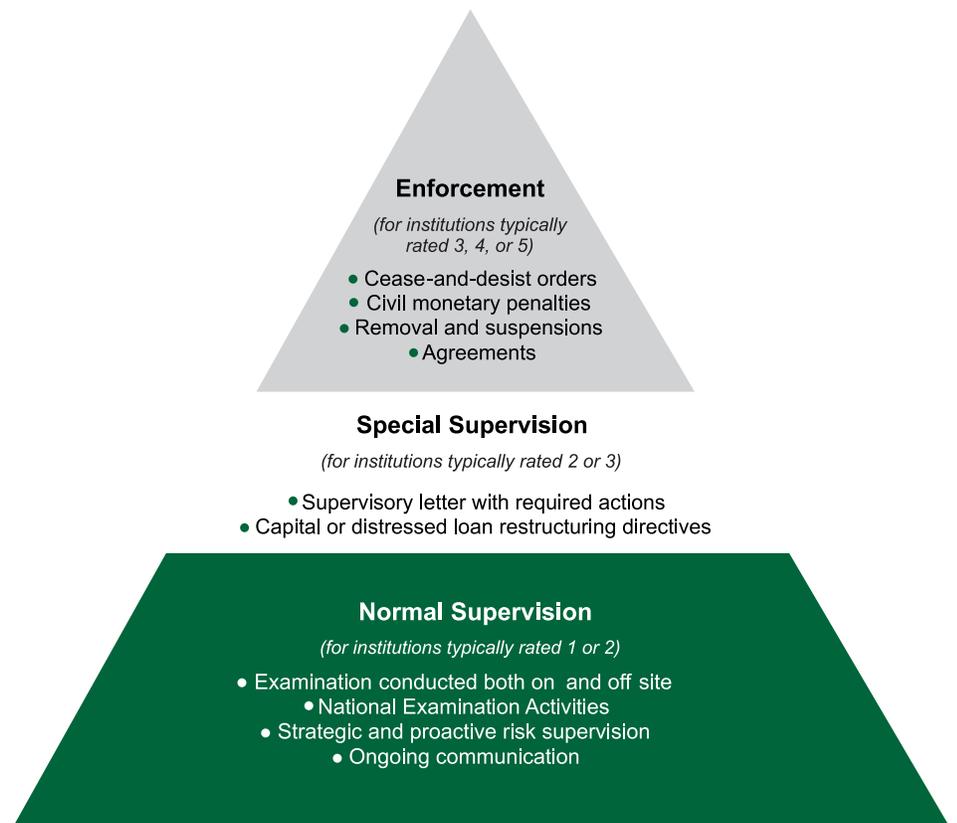
## Supervision and Enforcement

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 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 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.

### FCA's Levels of Supervision



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 (risk relationship to financial capacity) of an institution is considered to be weak and deteriorating, but its total condition does not justify a formal enforcement action.
- Unsatisfactory conditions or practices exist that, if not promptly and sufficiently addressed, may warrant formal enforcement action.
- The board and management recognize the identified safety and soundness or regulatory compliance weaknesses/concerns and are willing and able to correct them, and these actions are likely to resolve the concerns.
- The financial profile (earnings, liquidity, and quality of collateral in relationship to direct loan) 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. The institution is given an opportunity to correct the problems to avoid the need for a formal enforcement action.

If conditions in the institution deteriorate or financial and credit conditions worsen, a formal enforcement action may be warranted to establish managerial discipline and to put in place the controls needed to prevent further deterioration or the all-out failure of the institution. Enforcement Supervision is applicable to those 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 person 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 person 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.
- An institution or person 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 timeframes 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, 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 would be referred to as supervisory conditions of merger or reorganization, and they are imposed with the consent of the institution. Enforcement actions can be taken for 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. Agreements are used when problems are not severe enough to warrant a more stringent action and the board and management are able and willing to address the agreement’s requirements. 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 distressed loan restructuring directives. While directives are not considered enforcement documents, they are enforceable in the same manner and to the same extent as an effective and outstanding cease-and-desist order that has become final.

### *Cease-and-Desist Orders*

An order to cease and desist is issued to institutions and individuals when problems are severe. It also may be used when agreements or conditions have been violated that were imposed upon an institution in connection with an application (such as a merger or reorganization application). We may issue an order to cease and desist when

- an institution or person has engaged, is engaging, or is about to engage in an unsafe or unsound practice, or
- 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 person; or
  - ◆ any written agreement entered into 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 an order to cease and desist has been issued 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 prior to completion of a cease-and-desist proceeding.

The temporary order can require the institution or a specific party to stop the violation or practice described 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, if 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, and 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. We may assess up to \$1,100 per day for each day the institution or individual is in violation of a cease-and-desist order and up to \$750 per day for each day a violation of law or regulation continues.

Before we determine whether to assess a CMP, the offending individual or institution is given 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.

### *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

- the institution has suffered or probably will suffer substantial financial loss or other damage;
- the director or officer has received financial gain through a violation or unsound practice;
- the interests of the institution's shareholders or investors in System obligations could be seriously affected; or
- the violation, unsound practice, or breach of fiduciary duty involves personal dishonesty or demonstrates willful or continuing disregard for the safety and soundness of the institution.

Directors, officers, or other persons participating in the conduct of the affairs of an institution can also be removed from a System institution if their conduct or practice with respect to another business or System institution

- has caused a substantial financial loss or other damage,
- shows personal dishonesty or willful or continuing disregard for the entity's safety or soundness, or
- shows 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 deemed 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, the Farm Credit System Insurance Corporation as a conservator or receiver for the institution. 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.*

## Conclusion: Some Guiding Principles

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

- **Know the law and regulations.** Read and understand the Farm Credit Act and the FCA regulations. (Ask your management to provide a hard copy of the information or download it from the FCA website at [www.fca.gov/exam/handbook](http://www.fca.gov/exam/handbook).)
- **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. When acting in an official capacity, your personal interests and those of your family and your associates must be subordinate to the best interests of the institution. You should evaluate issues in terms of the institution's resources and capabilities, the reasonableness of risk and returns, and any potential adverse effects on your institution.
- **Become well informed.** Read financial statements and reports to the board, reports from management, and Reports of Examination with a critical eye. If something is not clear or needs further explanation, ask questions. Always ask yourself whether you have enough information to make an informed decision, and if you do not, find out where you can get the information you need. It is your responsibility to be well informed about the institution, its business environment, and current market practices.
- **Delegate wisely.** Business demands and legal standards that govern your institution's board require you to serve with dedication and vigilance. It cannot be overemphasized that, although you may delegate assignments, you may never delegate your responsibilities as a director. While you are encouraged, and in some cases required, to use board committees, the committees do not relieve you of your individual responsibility for the decisions you make and for ensuring that institution operations are delegated to people who merit confidence.

- **Avoid conflicts of interest.** Be familiar with the FCA regulations in part 612 addressing conflicts of interest and standards of conduct. Before you act on an institution business matter, ask yourself if you (or members of your family or other close associates) stand to personally gain from a matter. If so, consult with your institution's legal counsel and its standards of conduct officer to determine the appropriate method of dealing with the conflict, including the possibility of recusing yourself from the board deliberations and vote on the matter. When in doubt, the prudent course is likely to be to disclose and abstain from voting on or discussing the matter.
- **Make use of counsel.** Do not hesitate to seek legal counsel when considering internal investigations, application of the business judgment rule, or other matters affecting your role as director.
- **Select and retain competent management.** The most important factor in the success of an institution is the quality of its management. It is rare that the cause of a serious problem or the failure of an institution is other than mismanagement. You must stay keenly aware of management's activities. Your early detection of managerial problems can mean the difference between success and failure of the institution.
- **Be attentive to risk.** Your institution must assess risk and assume carefully calculated risks to be profitable. To manage those risks, it must establish a system that is adequate for its size and complexity of operations. You must be aware of the various risks confronting your institution, the magnitude of those risks, and management's ability to limit risk-taking to an acceptable level consistent with the board's strategy. The board and management must work together to ensure that they adequately identify, measure, monitor, and control risk.

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

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.

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

## 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 achieve this understanding by requiring and reviewing regular reports showing your institution's financial performance. These reports can help you

- assess your institution's financial condition,
- determine whether the risk taken by your institution is consistent with the board's philosophy, and
- 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. Further, the reports should periodically include comparisons to the budget and the board's business plan goals and objectives, as well as benchmarking between your institution and its peers. In all such comparisons, management should explain significant deviations. For financial information to be useful, it must be 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 page 7 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, see Report Descriptions located on the FCA website at [www.fca.gov/exam/descriptions.html](http://www.fca.gov/exam/descriptions.html).

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 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, FCA's website has the Six-Quarter Trend Report and the Six-Year Trend Report. 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.

## Capital Adequacy

FCA's Examination Manual (also available on FCA's website) contains two documents that discuss how FCA assigns ratings to individual institutions:

- EM-135—Financial Institution Rating System (FIRS)
- EM-199—Supplement 5—FIRS Guide

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

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

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

Your board of directors is charged with establishing optimal capital goals on the basis of your institution's particular circumstances and risk profile. Your institution's capital needs depend on its operating environment, portfolio risk, growth prospects, and other

risks that exist within the institution. You and your fellow board members must carefully monitor all components of capital to ensure an appropriate balance between shareholder ownership and unallocated surplus. The optimal capital goal is normally determined during the business planning process and reflects the risks faced by the institution—both existing and anticipated.

### *Key Capital Adequacy Measures*

**Regulatory Capital Ratios:** FCA has defined and set minimum regulatory levels for the following ratios:

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

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

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

Potential warning signs that capital levels may not be adequate include the following:

- The capital position is either declining, or it 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.
- Portfolio risk is increasing significantly, as evidenced by the level and trends of criticized, adverse, and nonaccrual assets.
- Capital ratios are significantly below peer averages.
- Capital levels are approaching the institution's minimum regulatory capital requirements.

## Earnings

An adequate and reliable earnings stream is fundamental to the maintenance of a safe and sound institution. Earnings represent your institution's first line of defense against capital depletion due to credit losses, interest rate risk, and other operational 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.

Your board's philosophy on earnings should be clearly documented in your institution's business and capital plans. Earnings philosophies address the composition of income, reflect the competitive environment, and address the need to generate an acceptable return on assets. Your review of earnings should focus on the quantity, quality, and trend of earnings. Reductions in the quantity and quality of earnings are usually related to excessive or inadequately managed credit risk or interest rate risk, or high operating costs. The quality of earnings may also be affected by reliance on extraordinary or nonrecurring events.

### *Key Earnings Ratios*

**Return on Assets:** Net income for the preceding 12 months divided by average assets; measures how efficiently the institution uses its assets to generate earnings.

**Net Interest Margin:** Net interest income (interest income, less interest expense) divided by average earning assets; 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; shows how many cents of overhead is spent to generate \$1 of revenue.

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

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

**Loanable Funds to Earning Assets:** Loanable funds (earning assets less interest-bearing liabilities) divided by earning assets; measures earning capacity of the institution.

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 is declining.
- Key earnings ratios compare unfavorably with those of 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 below the asset growth rate; this indicates earnings are insufficient to capitalize growth even when all earnings are retained.

Liquidity represents the ability to fund assets and meet obligations as they come due. Liquidity is critical to the ongoing viability of any institution and is among the most important management responsibilities at a financial institution.

The principles of liquidity management used by banks differ substantially from those used by associations. A bank should seek to maintain sufficient cash flow to fund operations, service debts, meet commitments to borrowers, and provide for funding contingencies; an association must maintain access to funding from the creditor bank. Sufficient liquidity is essential to accommodate for expected and unexpected balance sheet fluctuations and to provide for contingencies. The board of directors should maintain policies and strategies for the management of liquidity. In addition, banks should have contingency plans in place that outline strategies for handling liquidity crises or unanticipated funding events.

## Liquidity

The System's primary source of liquidity is its access as a Government-sponsored enterprise to debt capital markets. The banks obtain their principal sources of funding and liquidity from debt issued in the capital markets through the Federal Farm Credit Banks Funding Corporation. Secondary sources of liquidity are available through investment management in accordance with FCA regulations. Other sources of liquidity include lines of credit from commercial lenders. These lines of credit can provide an alternative source of liquidity in normal periods but can become expensive or quickly dissipate in an adverse operating environment.

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

### *Liquidity Ratios/Measurements*

**Days of Liquidity:** The number of days of maturing obligations that could be funded by 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.

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

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

**Quality of Assets Supporting the Direct Loan:** A measurement of the quality of assets that support the direct loan from the funding bank. This measurement, which applies to associations only, measures the amount of high-quality assets available to secure the direct loan with the institution's funding bank. Loans graded "acceptable" and "special mention" and accrual assets as a percentage of the direct loan are additional measures of the quality of assets supporting an association's direct loan.

Potential warning signs that liquidity levels are insufficient include the following:

- Real or perceived negative developments have occurred in either the internal or external operating environment.
- Asset quality has declined (resulting in a decline in the ratios that measure quality of assets supporting debt and a decline in the association's borrowing base margin).
- Financial performance or projections have declined.
- Rating agencies have downgraded, or announced that they may downgrade, the credit rating of the System or an FCS institution.
- Days of liquidity are approaching the regulatory minimum.
- Spreads of the institution's debt issuance have widened in comparison with other Government-sponsored enterprises.

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

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

- The board of directors of each FCS bank must develop and implement an IRR management program and incorporate an IRR management section into the asset/liability management policy. The section should establish IRR exposure limits, as well as the criteria to determine compliance with these limits.

## Sensitivity to Market Risk

- The board of directors of each FCS bank must develop and implement an IRR management program that is tailored to the needs of the institution and is consistent with the requirements set forth in the regulations.
- Each FCS bank's board of directors is responsible for providing effective oversight of the IRR management program, and the directors must be knowledgeable of the nature and level of IRR taken by the institution. The day-to-day management of IRR is placed with the senior management at the banks.
- FCA regulation § 615.5182 extends the requirements of §§ 615.5180 and 615.5181 to those associations with IRR that could lead to significant declines in net income or in the market value of capital.

To fulfill its responsibilities in the area of IRR, your board of directors should ensure that management effectively identifies, measures, monitors, and controls IRR. The complexity and level of risk should determine the sophistication of your institution's IRR management program.

The funding banks for most associations have used the transfer pricing program to limit the IRR that the associations can assume. As a result, the sophistication and analysis required to assess risk will be less at most associations. Nevertheless, the risks assumed should be clearly documented and measured, and the board should monitor the risks to ensure that conditions do not change. More complex institutions will need more formal, detailed IRR management programs. While management should establish sound controls and analyze all major risk exposures, the board of directors should understand the major risks that are being taken and ensure that controls surrounding the IRR management program are sound. At those institutions where the IRR is more complex, a thorough independent review of the IRR management program should be performed periodically. FCA recommends that directors unfamiliar with IRR concepts obtain training in this area.

## *Sensitivity Ratios/Measurements*

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

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

**Net Interest Income and Market Value of Equity Simulations:** Income simulation is used to forecast how net interest income changes in response to changes in interest rates. Market value of equity simulation shows possible changes in the market value of a bank's 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 simulations show the percentage change in net interest income and market value of equity for a given change in market interest rates. 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.

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

- Net interest income shows significant volatility.
- Management is not operating within the board's established limits.
- The amount of, and trend in, aggregate IRR exposure is increasing.
- Your institution has a high or increasing volume of assets with embedded options, such as fully prepayable fixed-rate loans or investments.
- Management reports are failing 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.

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

Because of the variation and complexity of risks in the institutions, FCA employs a risk-based examination and supervisory approach. Our examiners do not attempt to restrict risk-taking; they do, however, seek to determine whether institution management identifies, understands, and controls the risks they assume. As an organization grows more diverse and complex, its risk management processes must keep pace. When risk is not properly managed, 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 and to maintain capital commensurate with its risk.

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

The existence of risk is not necessarily a reason for concern. Even the existence of high risk is not necessarily a concern as long as management has the ability to effectively manage it. 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 (that is, those that do not meet the above 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.

## Appendix B: Examination and Supervision Based on Institution Risk

As discussed in the following paragraphs, we have defined seven categories of risk for institution examination and supervision purposes. 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 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
  - ◆ differences between the timing of rate changes and the timing of cash flows (re-pricing 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), and
  - ◆ interest-related options embedded in assets and liabilities (options risk).

Other secondary factors can also affect an institution's interest rate risk profile.

- **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 and products in a financial institution, including senior management, treasury, corporate accounting, credit risk, loan underwriting, and internal audit. It is a function of internal controls, information technology, employee integrity, and operating processes. (For information on governance issues related to information technology, see Appendix C.) Operational risk exists in all products and services; it arises on a daily basis in all financial institutions as transactions are processed and services are provided.
  
- **Compliance Risk:** The current and prospective risk to earnings or capital arising from violations of, or noncompliance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing 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
  - ◆ diminished reputation,
  - ◆ customer flight,
  - ◆ limited business opportunities,
  - ◆ lessened expansion potential, and
  - ◆ lack of contract enforceability.

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

- **Strategic Risk:** The risk to earnings or capital arising from
  - ◆ inadequate direction and control,
  - ◆ adverse business decisions,
  - ◆ lack of achievement in goals and objectives,
  - ◆ lack of adherence to policy direction, or
  - ◆ lack of responsiveness to industry or regulatory changes.

This risk is a function of the compatibility of the board's strategic goals, strategies to achieve those goals, and accountability for achieving the goals. The resources needed to carry out business strategies are both tangible and intangible; they include communication channels, operating systems, delivery networks, and managerial capabilities. An institution's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes.

- **Reputation Risk:** The risk to earnings and capital arising from negative public opinion. Negative public opinion can affect your institution's ability to maintain credibility as a viable institution, as well as its ability to establish new relationships with existing FCS institutions or other financial institutions. It can also affect your institution's ability to continue servicing existing customers. 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 exercise an abundance of caution in dealing with customers and the community.

## Appendix C: IT Governance

The pervasive use of technology in FCS institutions has created a critical dependence on information technology (IT); as a result of this dependence, institutions must address IT governance issues. Boards of directors of FCS institutions are responsible for an effective enterprise governance framework that includes IT. Like other governance subjects, IT governance is the responsibility of the board of directors and executives of System institutions.

You and your fellow board members can use the guidelines below to provide effective IT governance:

- Approve IT-related plans, policies, and major expenditures while ensuring that management has an effective strategic planning process that aligns IT strategy with enterprise strategy.
- Understand the institution's IT infrastructure and its components and remain aware of key IT topics, such as IT and information security policies, data center concepts and activities, and IT-related risks. Be aware of key system development and acquisition projects and how they support and affect overall corporate strategies, objectives, and short- and long-term budgets.
- Insist that an IT control framework be implemented, which includes IT policies and procedures, to ensure your institution's safety and soundness and its compliance with law, regulations, and IT-essential practices.
- Require regular reporting on IT system functionality and security, including periodic reporting by the institution's Chief Security Officer to the board or a committee of the board (such as the audit or risk committee).
- Ensure that your institution's internal audit and review program includes IT security within its audit scope and dedicates sufficient resources.

Many boards use committees that oversee critical areas of the institution to assist them in carrying out their governance duties. Your board may choose to delegate the responsibility for monitoring IT activities to a senior management committee or to an IT steering committee. If so, the responsibilities of the committee should be defined within a charter.

Using a committee enables your board to make decisions without becoming involved in routine operations. The committee's mission would be to assist the board in overseeing the institution's IT-related activities; however, the board remains ultimately responsible for these activities. The committee may consist of representatives from senior management, the IT department, and major end-user departments. Committee members do not have to be department heads but should know IT department policies, practices, and procedures. Each member should have the authority to make decisions within the group for his or her respective areas. In addition, the committee should ensure that the board has the information it needs to make the decisions that are essential to achieving the objectives of IT governance. Those objectives are as follows:

- To ensure that the information technologies adopted provide real value to the business
- To align IT objectives with business objectives
- To identify the best sources of information technologies and to ensure that the technologies are used effectively
- To manage IT-related risks
- To measure IT performance
- To research the benefits and risks associated with emerging technologies before your institution adopts them

The committee may help to ensure business alignment, effective strategic IT planning, and oversight of IT performance. The committee may also perform the following:

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

If you use a committee, it should provide general reviews to the board regarding major IT projects.

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