The Director's Role

Farm Credit System Institutions

Contents

0597/2000

Foreword

Election to the board of directors of a Farm Credit System (FCS or System) institution is an honor. It is an expression of stockholder confidence in the director's ability to oversee the institution's safe and sound operation for the benefit of member-borrowers. That honor, however, carries numerous responsibilities. This booklet provides guidance and information about the duties, responsibilities, relationships, and liabilities of FCS institution directors. Although written primarily for bank and association directors, the booklet has relevance for directors of service organizations as well. The booklet does not cover all of the ramifications of the director's role but describes some of its major components. It is not intended to be a substitute for consultation with legal counsel. Directors are urged to seek advice from legal counsel or other qualified advisors when faced with specific circumstances.

The Farm Credit Administration (FCA or Agency) wishes 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, and

Director Liability in Agricultural Cooperatives,
published by the Agricultural Cooperative Service, U.S. Department of Agriculture.

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Additional information about the Farm Credit Administration and the Farm Credit System is available on FCA's Home Page on the World Wide Web. The web site is located at http://www.fca.gov.

Introduction

The financial institutions and service organizations that comprise the FCS are federally chartered entities, organized to carry out the mandates of the Farm Credit Act of 1971, as amended (Act). This Act provides for a farmer-owned cooperative credit system that extends credit and related services to farmers, ranchers, and farm-related businesses.

System institutions are regulated and examined by the FCA, an independent agency in the executive branch of the U.S. Government. The FCA was initially created in 1933 by an Executive Order of President Franklin D. Roosevelt but now derives its powers from the Act. Regulations issued by the FCA have the full force and effect of law. Because the authority and responsibilities of System institutions and their directors are derived from Federal law and regulations, directors of these institutions need to be familiar with both.

The FCA helps directors and management keep informed of legal and regulatory matters, as well as other Agency concerns by disseminating a variety of materials to all System institutions:

- ***FCA Handbook.*** The *FCA Handbook*, which is updated as changes are made, contains statutes, regulations, FCA Bookletters, FCA Proposed Regulations, FCA Board Policy Statements, Title V Ethics Supplementals, and Farm Credit System Insurance Corporation (FCSIC) Regulations.

- ***FCA Examination Manual* and updates.** This manual contains concepts, guidelines, and procedures for the examination of FCS institutions.

- **Uniform Peer Performance Report (UPPR).** Produced quarterly, the UPPR provides comparable financial and operating ratios for like-sized institutions. Every quarter end, each FCS institution submits certain financial and operating information to the FCA. One product of the analysis of this information, the UPPR, can be particularly useful to institution directors. Institution directors can review this report and the accompanying "Guide for the Use of the UNIFORM PERFORMANCE REPORT and the UNIFORM PEER PERFORMANCE REPORT" to learn how their institution compares to others.

- **Report on Board actions.** After each FCA Board meeting, a report is issued on Board actions that have occurred since the previous Board meeting.

- **Pertinent Information.** Other pertinent information, such as announcements of public hearings and more detailed explanations of regulations, or other issues, is provided as needed.

The Board of Directors

Accountability and General Responsibilities

The Act provides that each Farm Credit System bank and association shall elect from among its voting members a board of directors of such number, for such terms, with such qualifications, and in such a manner as may be required by its by-laws, except that at least one member shall be elected by the other directors. The member(s) selected by the other directors shall not be a director, officer, employee, or stockholder of any System institution.

The board of a System institution, like that of any corporate organization, is elected to oversee the management of the institution. Directors, like other corporate directors, owe fiduciary duties to the institution and must exercise reasonable care in governing the institution's activities. However, directors of financial institutions, including System institutions, are generally held to a higher standard than those of corporations because they put the funds of others at risk through their lending activities. Depository institutions lend the funds of depositors. Farm Credit System institutions lend the funds of investors. Additionally, directors of System institutions are faced with another challenge because they and their fellow stockholders are also borrowers. Scrupulous objectivity is important when taking actions that may affect directors' interests as borrowers.

Directors are responsible for the profitable, safe, and sound operation of the institution regardless of economic and financial conditions in local, domestic, and international markets. The directors are thus accountable to shareholders and investors for the following:

- Understanding the institution's operations.
- Providing for competent institution management.
- Diligently performing their duties as directors.
- Exercising independent judgment.
- Remaining loyal to the institution's interests.

These distinct duties and responsibilities are explained in more detail throughout this booklet.

The ultimate responsibility for the conduct of the institution's affairs lies with its board of directors. The board establishes policies that govern how the institution carries out its business and ensures that those policies are implemented. 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's effectiveness will depend, in part, on how well its members know the business they are directing. It will also depend on how well they work together to identify and address issues that are important to the success of the institution. If candidates for board positions do not have financial experience, once elected they must diligently seek to understand the operations of the institution in order to faithfully execute their duties. Board composition is also important. Elected directors have an excellent opportunity to bring specialized financial institution management expertise, as well as other kinds of knowledge and skills, to the board through their selection of outside directors. Important new perspectives and objectivity can be provided by these individuals.

A well-organized board will examine the demands that will be placed upon it and identify areas that could be handled by committees. Matters that require detailed review or analysis might be better addressed in this manner. Serving on committees enables directors to develop more specialized knowledge of the institution's business. Typical committees include the Executive Committee, Loan Committee, Credit Review Committee, and Audit Committee, among others.

All committees should have clear written statements of their missions, authorities, responsibilities, and duration. Standing committees address continuing areas of responsibility, while ad hoc committees may be set up to handle special projects. It is also wise to rotate committee responsibilities to allow directors to broaden their knowledge and understanding of the institution's operations.

Committees should report regularly to the full board. The board may rely on information provided to it by committees, but the full board retains responsibility for all decisions. If such decisions are based on the recommendation of a committee, the board should assure itself that the committee has done its work responsibly and that its recommendations are reasonable.

The board can delegate management authority to the institution's officers, but too broad a delegation, without appropriate standards, is considered an abdication of its management functions. Delegation of such authority does not relieve the board of its legal responsibilities for the outcome.

The Board and the Farm Credit Administration

Directors must understand the Act, as well as the role, operations, and regulations of the FCA, because directors are ultimately responsible for ensuring that their institutions comply with statutory and regulatory mandates. The FCA regulates and examines System banks, associations, and related entities for compliance with applicable statutes, regulations, and safe and sound banking practices.

FCA policy is vested in a three-member board appointed by the President of the United States with the advice and consent of the Senate. FCA Board members serve 6-year terms and may not be reappointed after serving a full term or more than 3 years of a previous member's term. The President designates one member as chairman of the board. The chairman also serves as the Agency's chief executive officer (CEO). The FCA Board is responsible for Agency policy, promulgation of regulations to implement the Act, and enforcement activities. FCA provides for the examination and supervision of the System, including the Federal Agricultural Mortgage Corporation, approves corporate restructuring of System institutions, and oversees the FCS Building Association. The FCA Board also serves as the Board of Directors for the Farm Credit System Insurance Corporation, which was created to insure FCS securities.

The FCA Board and staff develop and interpret regulations and policies to accomplish FCA's mission. The Congress requires that the FCA examine all FCS institutions at least once each 18 months, with the exception of Federal Land Bank Associations, which must be examined at least once every three years. Approximately one-half of the Agency staff is engaged in the examination function. Staff engaged in examinations operate from field offices in various locations throughout the United States.

In the past, annual examinations followed prescribed procedures routinely required in every institution. Today, FCA examiners exercise flexibility in choosing just when certain examination procedures need to be followed. They make their decisions based upon their assessment of the nature and the degree of risk in each individual institution. This "risk-based" examination approach has resulted in a much more effective and efficient examination process. To the maximum extent possible, examiners complete "examination" work from FCA field offices, thereby avoiding travel costs and some of the disruption caused to institutions from examiner presence "on site." Also, examiners are able to tailor the interval between examinations to the individual institution's risk profiles. Smaller, well-managed, and sound institutions do not require the same amount of examination and oversight as do larger, more complex, or troubled institutions.

Because examinations, by their nature, frequently find flaws or weaknesses in institution operations, management may at times be defensive about examiner criticisms. Directors, however, should look upon the examination as an objective and external view of the institution. The Reports of Examination are much more informative as to the conditions observed by the examiners and the corrective actions needed. Directors may not necessarily agree with all of the examiners' conclusions, but they should make sure they understand and fully consider the basis for the criticism and how failure to address the criticism could affect the safety and soundness of the institution.

Upon completion of each examination, the board will receive a written report of the examiners' findings on the institution's condition and operations. At the same time, the examiners will issue an overall numerical rating of the institution. The FCA Rating System is similar to one used by other financial institution regulators; however, it has been modified to reflect the nondepository nature of FCS institutions. CAMEL is an acronym for Capital, Asset quality, Management, Earnings, and Liquidity. Each of these "components" is assigned a rating from one to five (one being the best), as well as an overall "composite" rating. These ratings and the composite rating are explained in the *Examination Manual*. FCA provides institution board members with the rating results to provide additional perspective on the condition of the institutions they lead, but urges directors not to focus too heavily upon the ratings by themselves.

The examiners will make themselves available to meet with the board of directors, present their findings, and respond to questions from the board members. Most of the time, institution management is invited to take part in the meetings. But each meeting should provide an opportunity for the board members to meet in "executive session" with the examiners without management present. Experience has shown that these private sessions are greatly appreciated by directors as they provide a free and open forum for discussions with examiners. In preparing for a meeting with the examiners, directors are advised to read the Report of Examination thoroughly and any accompanying correspondence, come to the meetings with a list of any questions, and feel free to ask questions.

The Report of Examination in no way diminishes the directors' responsibility to oversee the institution's operations. Rather, it is an important business tool to help the board monitor the institution's affairs. The institution's board has a duty to address the report's findings and take appropriate corrective actions in a timely manner. During subsequent examinations, FCA will evaluate the extent and effectiveness of the directors' efforts to resolve any problems noted in the previous examinations.

The Board's Role in Strategic Direction and Business Planning

The System and the financial services industry have undergone unprecedented changes, making planning for the future all the more important. Planning is vital to the long-term success of the institution because it translates the board's vision into measurable goals with strategies to achieve them. Only by knowing what the institution is and what it wants to become can a board know whether it has the financial and human resources and technological and organizational capabilities necessary to reach its goals.

The planning process should be dynamic and ongoing. In its simplest terms, planning is the process of determining: (1) where the institution is; (2) where it would like to be; and (3) how it plans to get there. Planning can be divided into two components, strategic and operational. Strategic planning is an ongoing process that focuses on the long-term deployment of resources to achieve institutional goals. Operational planning concentrates on short-term actions, which should flow logically from the strategic plan and be revised periodically. The process begins with the development of a long-term plan that states the board's overall philosophy and its vision of the institution's future. Planning should detail strategies for attaining the short-term, sometimes routine, elements of business operations, as well as long-term goals. Short-term business plans should translate into long-term goals with specific, measurable targets.

The plan should identify those areas selected for strategic development, allocate resources, and provide the basis on which business decisions can be made and performance measured. Several strategies may be involved in achieving a particular goal. If, for example, the goal is to attain a certain net worth position, there may be strategies regarding the retention of capital, level of earnings, and asset growth that the business plan will incorporate. The board should ensure that its strategies and the use of institution resources will reasonably accomplish the intended purposes.

A key area for board consideration during planning is measuring and managing risk exposure. It is important for the board to understand what risks exist within an institution. The board must learn what causes risks and how they could affect the economic value of equity and net interest income under various economic scenarios. Once risks are defined and projected and capital needs are determined, the board should require management to explore alternative methods for managing risk exposures. Goals and strategies may be required to manage risks appropriately.

The board should establish reporting requirements for each component of the plan and review the institution's performance at least quarterly to evaluate the appropriateness of both the strategic and operational components. During the review, directors should consider new opportunities, any changes in the operating environment, and external developments to decide whether adjustments to the strategic direction are needed. The board should establish contingency plans in case actual results vary from planned goals and objectives.

The Board's Policy-Making Role

Because the board is ultimately responsible for the successful operations of the institution, it is essential that policies approved by the board provide direction to management. Many policies are required by statute or regulations. Beyond what is required by law or regulation, policies should cover every significant aspect of the institution's operations. Generally, policies are needed for each area of operations that plays a role in the institution's pursuit of its mission and discharge of its chartered authorities. They may also be needed to cover specific institutional programs or activities. The institution's charter or by-laws may spell out what areas require policy direction.

Policies can be developed in a number of ways. For instance, the full board might establish broad guidelines and set a general direction for a given policy. Responsibility for more detailed aspects of a policy might then be delegated to a board committee or to management. Using this approach, for example, the full board would adopt a general policy statement on standards of quality that must be met before credit is extended. The appropriate committee of the board would outline the specific elements to be addressed in the policy. Management would then prepare the details necessary to address those elements and the manner in which they are to be implemented. In another case, after providing general guidance and direction, the board might delegate the entire drafting of the policy and procedures to management. No matter how policies are developed, they are ultimately approved by the board and the board remains responsible for them. Before approving policies, the board must assure itself that they are appropriate for the institution and supportive of strategic objectives.

The board should ensure that policies are thoroughly understood at all levels of the institution. This is best done through written documents that can be maintained in a policy manual providing a single and authoritative reference. A better understanding of more complicated policies and procedures can be gained through training programs.

Regardless of the process used in policy development, an effective policy should include or address the following components:

- ***Purpose:*** A statement of purpose should clearly articulate the intention behind the policy or the policy's goals. The purpose of some policies is straightforward and relates to specific areas, such as loan programs, human resources management, or capitalization and dividends.

- ***Objectives:*** Policy objectives may be simple statements that require the institution to comply with a specific law, regulation, or business practice. Objectives may be linked to specific business plan goals, such as capitalization, earnings, asset growth, or interest rates; or the objectives may address expectations, such as 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 a committee thereof. 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 the 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 approval or review by the board. The board must ensure that delegated and retained authorities are appropriate and that the board is neither abdicating its authority nor unnecessarily restricting the institution's operations.

- ***Exceptions to board policy:*** Unexpected and urgent matters may arise that require immediate attention and greater authority than has been delegated to management. The board's policy should clearly define a process to handle such contingencies.

- ***Reporting requirements:*** Each policy should have well-defined reporting requirements for management. 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 should enable directors to evaluate the policy's effectiveness and impact. They should include actions taken under delegated authorities and actions taken as exceptions to policy. The overall body of reporting requirements set by board policy should provide sufficient information to keep the board fully apprised of the institution's business affairs.

Appendix A of this booklet describes some of the more important areas that should be covered by policies and suggests some elements which should be included in them.

The board should periodically evaluate whether policies are accomplishing their intended objectives and goals. Typically, the internal auditor evaluates the institution's compliance with board policy, and management evaluates the policies' effectiveness. In some instances, the internal auditor may evaluate both compliance and effectiveness. The board might schedule the review of certain policies at board meetings or provide a committee to review policies on a regular basis. However, 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, for example. The board must ensure that policies adequately direct and control the business affairs of the institution at all times. Hence, policies should be reevaluated and revised as necessary to ensure the successful operations of the institution.

The Board's Oversight Role

The Board has an ongoing responsibility to oversee the performance and effectiveness of the institution's operations. A System institution is in business to furnish sound, adequate, and constructive credit and related services to eligible applicants and borrowers. Therefore, sound business performance must be one of the board's primary objectives. It is also a key indicator of the board's success in directing the institution.

***Financial performance*:** For an institution to remain in business, it must be profitable and maintain adequate capital. Thus, financial performance is more than how much was earned; it is the quality of earnings over the long term. Quality earnings result from fundamental strengths—quality assets that can weather adversity, well-controlled expenses, effective asset/liability management, proper loan pricing, and knowledge of the competitive market and operating environment. To evaluate the quality of earnings, directors must understand the institution's entire operations and the relationships among operating statistics. The board should evaluate the institution's business carefully, looking behind the numbers to verify that earnings are not artificially inflated with delays in chargeoffs or insufficient provisions for loan losses. Reports by independent public accountants and internal reviewers, as well as FCA examination reports, may assist directors in ensuring reliability of reports to the board and shareholders.

Directors are not expected to be financial experts, but they should know enough to discern poor operating performance (or enlist the help of someone who does). They should evaluate performance against the institution's own targets and the performance of like institutions. There are no model numbers or ratios that guarantee success. Rather, board members need solid financial data and analyses and should probe the institution's financial and operating results by asking such questions as:

- Is management meeting the targets established in the business plan? If not, why not?

- 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 the institution's financial picture, or are they distorted by an incomplete evaluation of asset quality or potential losses?

Directors are not expected to have all the answers, but they must ask the right questions and assure that responsible answers are provided.

The board should be provided with extensive financial information so that the institution's performance can be evaluated. Some of this information is presented as key financial ratios and data relating to critical aspects of operational performance. The board should understand the significance of and trends in these ratios. Appendix B discusses a few key financial ratios in an effort to help directors familiarize themselves with and track the institution's financial performance.

Asset Quality: System institutions exist to lend money to agricultural producers and their cooperatives, and the resulting loans become the principal assets of the institutions. Therefore, the quality of those assets are of paramount importance. There are some key indicators that measure changes in asset quality. The number and amount of performing, criticized, adversely classified, restructured, high-risk, past due and nonaccruing loans reflect the quality of assets and directly affect the lending institution's overall condition. Management should fully explain any variation in the quality or volume of loans. The board should closely monitor the findings of the internal credit review and any weaknesses discovered in lending processes and practices. Sufficient controls need to be in place so that assets are managed in accordance with sound business practices.

Asset quality statistics should clearly and concisely show both the institution's current position and its trends. The volumes and percentages of each loan risk category should be discussed so that the board understands the reasons for any changes and can thus evaluate its underwriting standards and lending policies. Unusually poor asset quality may reflect weaknesses in lending policies or inadequate underwriting standards, both of which require prompt corrective action. Similarly, problems with nonearning assets, which include nonaccrual loans and acquired properties, also require prompt corrective action. The board should recognize that although deviations from acceptable asset quality may occur periodically, the board is ultimately accountable for ensuring that lending programs preserve the institution's safety and soundness, regardless of the operating environment.

Any institution can eventually encounter problem credits. Sometimes they result from a breakdown within the institution which requires quick board correction of the "process" problem that led to the troubles. Sometimes they result from unforeseen circumstances beyond the institution's control. In any event, it is important that problem credits receive close attention. A plan of correction or collection should be put in place on each troubled credit. In many instances, the board may wish to approve the individual correction plan and be provided with periodic progress reports. But in all instances, the board members should assure themselves that plans are being put in place and are being followed. A neglected problem credit is more likely to result in loss than one that is well administered.

***Managing Capital*:** One of the board's most important responsibilities is ensuring that the institution has sufficient capital to accomplish its mission, goals, and objectives. Establishing capital goals should not be limited to FCA regulatory requirements because these requirements only prescribe the minimum required of each institution. An institution's capital needs depend on its operating environment, risks that exist within the institution, and the 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. Most institutions will likely require more capital than the mere minimum. A determination of the amount of capital appropriate for an institution should result from the board and management's analysis. Most importantly, capital levels should be reflective of the risks within the institution—existing and planned.

The Board's Relationship with Management

As previously stated, the board of directors has the ultimate responsibility for the affairs of the institution it was elected to serve. The board can fulfill that responsibility only by assuring that the day-to-day operations of the institution are properly managed. Quality management is perhaps the single most important element in a soundly run and successful operation. However, the board and management must work together as a team in pursuit of continuing excellence in providing credit and related services to borrowers, as well as in maintaining the safety and soundness of the institution.

The board is responsible for hiring the CEO of the institution. The CEO must have the expertise necessary to assist the board in many ways. Integrity, education, technical competence, and sound credit, lending, and management experience should be key considerations in the selection process. In a borrower-owned credit institution, management should also understand the cooperative philosophy and principles upon which the institution is based. That should not detract, however, from the necessity of operating the institution as a profit-oriented business that must maintain financial stability and serve future generations of borrowers. Short-term problems must not be allowed to affect long-term objectives. In this regard, the quality and strength of the institution's management may be the difference between success and failure during difficult economic times or swings in the farm economy.

A formal process instituted by the board to evaluate management performance helps to ensure that periodic evaluations are a part of the ordinary course of business and demonstrates that the board is discharging its responsibility for supervising management. Clear standards of performance and measurable key result areas should be defined to ensure that management fully understands the board's performance expectations and that it is accountable for fulfilling those expectations.

The business success of the institution, its record in complying with applicable laws and regulations, and management's responsiveness to board directives are among factors that should be evaluated. The timeliness, quality, and accuracy of management's recommendations and reports to the board and its adherence to the institution's business plan should also be considered. Information that can be used in the evaluation include Reports of Examination, audit reports, and internal business performance and credit quality indicators. The degree to which the institution's objectives have been achieved, actual versus projected performance, and comparisons with like or similar institutions are other measurements that can be used.

If performance expectations are not being met between the formal periodic performance evaluations, it is the responsibility of the board to deal with the situation immediately. Although timely and effective communication may prevent serious problems from developing, occasionally the board will find it necessary to dismiss management for poor performance, dishonesty, conflicts of interest, or other reasons. When such circumstances dictate, a board's failure to do so expeditiously may represent a serious breach of its responsibilities.

Board responsibility includes identifying and developing a successor to assume the reins of management if a vacancy occurs. The board should have a succession policy for the chief executive officer. If no individual in the institution is suitable to succeed the CEO, a competent and experienced temporary replacement should be identified. Contingency plans should be reviewed annually, because one measure of a good CEO is the strength of the management chain. The CEO should be required to have a succession plan for other management levels.

Legal Responsibilities of Directors

This chapter discusses how the law affects a director's performance and in what ways a director may be held personally accountable for wrongdoing. System institutions are governed by the Act and subject to other Federal law and regulations. Common law and statutory provisions, including Federal statutes and state corporate and fiduciary statutes, often address the same conduct. Hence, a lawsuit against a director could allege a violation of common law or statutory law. A director who fails to comply with statutory or regulatory mandates, engages in unsafe or unsound practices, or breaches a fiduciary duty (or permits another person to do so) may be held personally liable and subject to monetary penalties or other sanctions. The director may be held responsible either alone or jointly with other board members in lawsuits brought by shareholders/investors and in Agency enforcement actions.

Common Law Liability

In addition to the standards established by Federal law and regulations, there is also a body of common law against which the performance of directors is measured. Common law is that body of law that is made up of cases decided by the courts and that constitutes generally accepted legal principles. In the exercise of the institution's corporate powers, directors owe common law duties to the institution and its stockholders similar to the fiduciary duties of a trustee.

By virtue of accepting the position, the director assumes a fiduciary duty to the institution and its stockholders (and in some instances, to its creditors) and is therefore liable for damages resulting from a breach of that duty. A fiduciary status signifies a special relationship between a director and the institution, which is characterized by trust and confidence in the director and his or her integrity. It also imposes certain obligations the director owes to the institution. The fiduciary duties of a director are typically described as the duties of due care, obedience, and loyalty.

Due Care: The duty of due care holds directors to a standard of care in performing their job equal to that which a reasonable and prudent person would exercise in similar circumstances. 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. Courts often will consider special factors that might affect how the hypothetical director would act. As explained below, the duty of due care carries with it the obligation to investigate and to exercise the care of a prudent person in making decisions on behalf of the institution.

When circumstances alert directors to an actual or potential problem, the duty to investigate requires that they learn the facts and resolve the situation. Not only must directors act in a careful manner, but they must also not *neglect to act*. For instance, a director who learns about an auditor's or examiner's criticism, whether by informal communication or written report, must make sure that the board and management review the matter and take any needed corrective action. Similarly, a director may be responsible for monitoring resolution of a problem to prevent recurrences. Directors have been held liable for failure to attend board meetings, failure to maintain adequate audit procedures, permitting false statements to be made in reports, failure to supervise excessive loans to a delinquent borrower, and failure to examine reports (including Reports of Examination) that pointed out problems warranting attention.

Obedience: The duty of obedience requires the director to act within the limits of power granted by the institution's charter, articles of incorporation, by-laws, statutes, and regulations. In order to discharge this duty faithfully, directors must familiarize themselves with the legal constraints under which the institution operates and seek legal counsel when they are uncertain about whether a particular action is authorized. Directors must also keep themselves sufficiently informed about the institution's activities to provide adequate supervision of management.

Loyalty: The duty of loyalty generally prohibits directors from placing their personal or business interests or those of others above the interests of the institution. Directors must deal fairly with the institution, refrain from letting personal interests affect their decisions, and always act honestly and in good faith. The duty of loyalty does not mean that directors absolutely may not do business with the institution or participate in transactions in which the institution may have an interest. It does mean that directors must disclose fully to the board any personal interest they may have in matters affecting the institution and ensure that any transactions involving these interests are evaluated and decisions are made by disinterested directors. The duty of loyalty requires directors to adhere to standards of fairness, avoid the usurpation of corporate opportunity, avoid misusing their position, and disclose conflicts of interest.

Additional Considerations

Fairness: Directors must observe strict standards of fairness in handling their own transactions and those of other member-borrowers. Directors must never favor some member-borrowers over others who are similarly situated.

Usurpation of Corporate Opportunity: Prohibits directors from taking personal advantage of business opportunities that might benefit the institution without first offering those opportunities to the institution.

Other Misuse of Position: Directors must not use influence or knowledge acquired through their official position for personal gain or the gain of others. Directors must deal with the institution's assets solely for the benefit of the institution and its member-borrowers. Institution assets must not be appropriated, given away, or wasted.

Disclosing Conflicts of Interest: Any time a director stands to gain personally from a proposed action or inaction by the institution, a conflict of interest may exist; the legal and regulatory problems that directors encounter often result from such conflicts. When directors question a possible conflict of interest, they should ask the institution's standards of conduct officer whether an actual or apparent conflict exists and whether they can participate in considering the matter at issue. Appendix C contains some specific statutory and regulatory citations, as well as prohibitions, dealing with conflicts of interest. In all jurisdictions, directors are required to disclose conflicts of interest with the institution and refrain from considering or voting on any matter in which a conflict exists and from attempting to influence the vote of others on such matters. A prudent director will avoid even the appearance of a conflict of interest by disclosing the apparent conflict to the institution and refraining from considering or voting on the matter.

The Business Judgment Rule

Directors are not expected to be insurers or guarantors of the institution's success or of the conduct of its officers. Nor are they expected to be all-knowing in their business decisions regarding the institution. Directors are expected, however, to carry out their duties in good faith, in the best interest of the institution, with diligence, and with the exercise of unbiased, independent judgment.

A director who has done so may be protected from liability by the business judgment rule. This doctrine recognizes that without allowance for honest error, no director could afford to be associated with the position. It means that courts will not second-guess the director's decision, even though it may turn out to be wrong and bring hardship to the institution. However, in order to invoke this business judgment rule, the director must first have fully met the duties of care and diligence implicit therein. The director's decision-making process involves careful consideration of the reasonably available and relevant facts necessary to making a well-informed decision, and the director must honestly and reasonably believe that the decision was in the best interest of the institution. It is also important to document the board's decision-making process, as 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 by a board than if there is no record or an insufficient one.

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 directors reasonably rely on others, they are protected from liability if they are misled or given incorrect information. However, directors are not protected if they rely on information provided by an officer or expert whom the director has reason to doubt because of factual information the director knows or should know. In addition, directors should not rely on officers or experts for decisions on matters that directors are charged with deciding. When the line between facts and judgments is blurred, which is often the case, directors should not unduly rely on the views of others.

In addition to liability for breach of fiduciary duty and negligence, directors can be liable for intentional torts, such as fraud or misrepresentation, when third persons are injured, even though the action was on behalf of the institution. Federal securities laws impose civil liability for fraud or misrepresentation in connection with the sale of securities. Thus, directors must exercise care in the certification of financial statements and collateral because Farm Credit Bank securities are issued on the basis of such certification.

Farm Credit Administration Enforcement Authorities

When directors breach a fiduciary duty, violate the laws governing their conduct, cause or permit persons associated with the institution to violate laws, or act in a way that would adversely affect the institution's condition, regulatory agencies can take action to correct the problem and hold the wrongdoer responsible. An institution director, employee, agent, or other person participating in the conduct of the affairs of an institution can be required to refrain from specific acts or take positive steps to correct the problem. A director (or other party) might also have to pay a penalty for violating the law or failing to take action required in an enforcement document.

The Farm Credit Act Amendments of 1985 granted the FCA enforcement authorities similar to those of other Federal financial regulatory agencies such as the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Federal Home Loan Bank Board (succeeded by the Office of Thrift Supervision), and the National Credit Union Administration. These authorities provide FCA with appropriate power to ensure that System institutions and their associated parties comply with laws and regulations and operate in a safe and sound manner.

Enforcement actions served upon an institution or an individual are determined on a case-by-case basis, with consideration given to correcting current deficiencies and preventing future problems. If FCA brings an action, the institution's directors will usually be asked to meet with Agency personnel who will present the enforcement action deemed appropriate for the institution.

Enforcement actions are taken to correct specific problems, and directors are ultimately responsible for ensuring that the institution complies with the action(s). Typically, they specify steps the institution must take to rectify problems described in Reports of Examination. An action is terminated in one of two ways: (1) by the Agency when it determines that the institution has substantially complied with the terms of the enforcement action and its overall condition has significantly improved; or (2) by a reviewing court.

Enforcement actions can take one of several forms, depending on the seriousness of the situation and the institution's willingness and ability to address the problem(s). The Agency can enter into written agreements, issue orders to cease and desist, temporary orders to cease and desist, and orders of removal and suspension. The Agency can also impose civil money penalties.

Agreements

An agreement is a written document between the institution or individual and the FCA that affirms the specified remedial actions necessary 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. If an institution or individual fails to comply with a written agreement, FCA may institute cease and desist proceedings.

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 written agreements or conditions imposed on an institution in connection with the granting of an application have been violated. 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 activities be stopped, or both.

All cease and desist proceedings begin with a notice of charges served to the affected institution or party. The notice sets forth allegations regarding the unsafe or unsound practices and/or any violations of law, regulations, written agreements, or conditions that have been identified by FCA. Generally, when a notice of charges is issued to an institution, FCA asks the institution's board to consent to the cease and desist order. The number of board members required to take any board action, as stipulated in the institution's by-laws, must agree to the order. If the party charged consents to a cease and desist order, the matter does not proceed to an administrative hearing and the order is effective upon execution by the board.

If consent to the order is not obtained, the notice of charges must be answered within 20 days of service, and the matter proceeds to a formal hearing before an administrative law judge (ALJ). After a hearing at which the parties present evidence to the ALJ that a violation or unsafe or unsound practice has or has not occurred, the ALJ submits a recommended decision to the FCA Board which 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 United States 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 or a reviewing court.

Temporary Cease and Desist Orders

The FCA 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 (1) cause insolvency, (2) cause substantial dissipation of assets or earnings, (3) seriously weaken the condition of the institution, or (4) 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 and/or take corrective action. Unless the temporary order is set aside by court order, it is effective 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 dismissal of the charges.

Removals and Suspensions

The FCA may initiate action to remove a director, officer, or other persons (e.g., employee, accountant, attorney) from serving at an institution for violating a law or regulation, engaging in an unsafe and unsound practice, violating a final order to cease and desist, or otherwise breaching a fiduciary duty. The Agency can suspend the individual from participating in the institution's affairs, if necessary, while removal proceedings are under way. Unless stayed by a court, a suspension is effective upon written notice by FCA and remains in effect until the removal proceedings are completed or dismissed.

To remove a director or officer, FCA must determine that, in addition to the violation, unsound practice, or breach of fiduciary duty referenced above: (1) the institution has suffered or probably will suffer either substantial financial loss or other damage; (2) the director or officer has received financial gain by reason of such violation or practice; or (3) the interests of the institution's shareholders or investors in System obligations could be seriously prejudiced, and that 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: (1) has caused a substantial financial loss or other damage; (2) evidences personal dishonesty or willful or continuing disregard for the entity's safety or soundness; and (3) shows that the individual is unfit to remain involved in the institution's affairs.

The FCA begins proceedings to remove individuals by serving written notice to them of the Agency's intent. The notice states the grounds for the action and the time and place of a formal administrative hearing. If the person does not consent to removal, the matter proceeds to hearing. Based on a review of the hearing record and recommendations of the ALJ, the FCA Board decides whether to remove the individual. A removal order may be reviewed by the appropriate United States Court of Appeals. Once in place, a removal or suspension order prohibits the person from participating in any manner in the affairs of the institution.

The FCA can also suspend or remove an individual charged with or convicted of a crime involving dishonesty or breach of trust punishable by imprisonment for more than 1 year. The FCA must show 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. Within 30 days of service, the person may request an informal hearing before FCA to modify or terminate the suspension or removal order. A suspension remains in effect until terminated by FCA or until the criminal charge is finally settled. At such time as the conviction is not subject to further appeal, FCA can order the individual's removal from office or prohibit the individual from further participation in the institution's affairs.

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. A CMP can be assessed against an institution or individual for violating the Act, regulations issued under the Act, or an order to cease and desist. The FCA may assess up to $1,100 per day for each day an institution or individual is in violation of a cease and desist order and up to $550 per day for each day a violation of law or regulation continues. Pursuant to the Debt Collection Improvement Act of 1996, every Federal agency, including the FCA, must adjust each CMP under its jurisdiction by the rate of inflation at least every 4 years. Because the CMPs were last adjusted in October 1996, the FCA must adjust them again prior to October 2000.

Before determining whether to assess a CMP, the offending individual or institution is given an opportunity to submit relevant information that addresses the violation. Once FCA reviews 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, the individual or institution is afforded the same hearing procedures that apply to cease and desist orders. If the evidence supports the allegations, FCA can order the offending party to pay the penalty. The party can seek review of the assessment by the appropriate U.S. Court of Appeals, but if the individual or institution fails to pay the assessment after it becomes final, FCA may refer the matter to the Department of Justice for collection.

Some Guiding Principles

The preceding commentary may be of some concern to the would-be director. To be sure, there appear to be myriad pitfalls to successfully serving as a member of a board of directors of an institution. But some simple guiding principles will help.

- ***Know the law and regulations*:** Read and understand the Act and the FCA regulations and policy guidance. (Ask management to provide this information, if it has not already been made available.)

- ***Do your homework:*** Read financial statements and reports to the board, reports from management, and Reports of Examination with a critical eye. If something is not clear, needs further explanation, or raises questions, make additional inquiry. Always ask yourself whether you have enough information to make an informed decision.

- ***Delegate wisely:*** Make sure institution operations are properly delegated to people who merit confidence. Regularly review the institution's performance and hold management accountable. Be prepared to seek a change in management if necessary.

- ***Avoid conflicts of interest*:** Be familiar with the FCA regulations addressing director conflicts of interest as well as the institution's policies and procedures on director standards of conduct. Ask yourself if you (or members of your family or other close associates) stand to personally gain from a matter. Consult with or disclose the personal interest to corporate counsel or the institution's standards of conduct officer and the board so that an appropriate method of dealing with the conflict may be devised. 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:*** Use counsel to assist in internal investigations, to clarify legal issues that may restrict the application of the business judgment rule, and to separate matters purely for the board's business judgment from other matters. Make sure that counsel is free to exercise his or her legal judgment in the best interest of the institution.

Conclusion

Although there are laws and regulations to guide the Farm Credit 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. Directors 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 the institution to thrive and serve its members. Their integrity must be unimpeachable, and their dedication to the job unfailing. As the regulator of the System, FCA stands ready to help directors understand and execute their duties. The FCA welcomes your comments and queries.

APPENDIX A– Major Policy Areas

The principal operational areas that require specific board policies include credit and lending programs, internal credit reviews and internal audits, asset/liability management, earnings (including the establishment of interest rates), liquidity management, and the maintenance of adequate allowances for losses. This appendix is not intended to be an exhaustive discussion of every policy an institution board should develop. Rather, it is a discussion of a few essential ones.

Credit

System institutions must establish adequate direction and control for all aspects of lending programs. In order to effectively manage risk, board-approved underwriting standards must be incorporated into lending policies or operating procedures for each of the institution's lending programs. These underwriting standards must maintain risk within the institution's risk-bearing capacity, build its financial strength, and adequately serve its territory. Underwriting standards should be reviewed frequently to ensure that they are appropriate and preclude making low-quality loans. Low-quality loans may increase interest income in the short term but can be detrimental to an institution's financial soundness in the long term. All lending policies must result in sound and constructive credit that will preserve and strengthen the institution's financial condition and performance.

Basic principles for sound lending: Lending policies should prescribe that borrowers have adequate means to repay a loan in accordance with the terms established in loan agreements. If collateral is taken it should be of sufficient value to minimize the risk of loss to the institution if the borrower fails to repay the loan. The loan agreement should limit risk exposure and enable the institution to act quickly in the event the borrower does not comply with the terms established. Finally, lending policies should dictate that loans be made to individuals who manage their business affairs and operations in a manner that preserves the quality of collateral and results in compliance with all terms specified in lending agreements. Other stipulations to consider including in lending policies are as follows:

- Minimum supporting credit and financial information, frequency for collection of information, and verification of information required in relation to loan size, complexity, and risk exposures.
- Procedures to be followed in credit analysis.
- Minimum standards for loan disbursement, servicing, and collections.
- Requirements and methods for handling collateral.
- Loan approval delegations and requirements for reporting to the board.
- Loan pricing practices.

- Loan underwriting standards that (1) include measures for determining if an applicant has the operational, financial, and management resources necessary to repay the debt from cash flow, (2) are appropriate for each loan program and the institution's risk-bearing ability, and (3) consider the nature and type of credit risk, amount of the loan, and enterprise being financed.

- Requirement that loan terms and conditions are appropriate for loan purposes.

- Documentation in each loan file of compliance with loan underwriting standards. Or, the compensating factors or extenuating circumstances that establish repayment capacity in justification of an exception to underwriting standards.

Concentrations: Clearly-defined limits for concentrations of risk are essential components of the board's control of credit exposure. Although FCA regulations establish limits on large loans, considerable risk can exist when loans are concentrated in a few industries. Accordingly, the board should carefully evaluate the lending environment to determine the types of credit and operating parameters needed. If lending is concentrated in single entities, large loans, or specific industries, the board may want to limit such concentrations and develop alternative lending programs that will diversify the institution's earning stream and insulate capital from excessive exposure. For example, the board may decide that the institution's portfolio should limit exposures to single entities as a percent of the established capital base or as a percent of interest income (e.g., cattle feedlot loans may not exceed 20 percent of permanent capital).

Managing concentrations: Substantial exposure should be appropriately managed. Although board policies should not discourage credit to any creditworthy applicant, they must also provide mechanisms for management to simultaneously diversify excess exposures through the sale of loan assets when established limits on concentrations have been reached. Institutions often have policies for purchasing participating interests in loans (participations) or entering into syndications to manage concentrations by diversifying their loan portfolio. However, an institution must make an independent judgment on participations purchased and must never participate in a loan that it could not otherwise make within its legal lending authorities or that does not meet its credit standards. And, it should have sufficient lending personnel and expertise to adequately analyze and service the risk in any loan or participation purchased from other institutions. Institutions that extend credit or participate in loans without having adequately trained staff or adequate lending expertise are not adhering to safe and sound lending practices.

Insider loans: Loans to insiders–directors, officers, employees (or their relatives)–must be handled carefully to avoid even the appearance of preferential treatment or insider dealings. Accordingly, policies for insider loans must scrupulously assure that such loans are granted within the authorities of the institution and in accordance with sound and constructive credit practices. The terms, conditions, and interest rates for such loans must be no more favorable than those afforded to like borrowers, and the process of approval must not permit the involvement of the insider.

Delegated lending authorities: The board is not required to participate in the loan approval process, but neither is it prohibited from doing so, when necessary. Management and lending officials (or a committee thereof) typically carry out the institution's lending programs. However, certain loans may require specific board approval or authorization because of the amount of the loan, the concentration of risk, or other factors. Thus, lending policies must clearly define the authorities delegated to management, as well as those reserved for the board (or committee). If the board reserves certain loan approval responsibilities for its action, directors must recuse themselves from action on loans in which they have an interest as defined by the FCA regulations governing standards of conduct. Finally, the lending approval process must be understood by all personnel who make or service loans.

Internal and External Reviews and Audits

Internal audits: The board should carefully review the risks to the institution from other operational areas and should schedule independent reviews of those areas within a specified period. These areas should then be audited to make certain that operations are in accordance with board policies and sound business practices. The board should set a schedule for internal audits of operational areas not specifically addressed by the independent credit review.

Internal credit review: An ongoing internal credit review process is essential to identify and manage risk accurately. Therefore, internal review and audit policies should ensure that the institution maintains a process that: (1) routinely classifies loans in accordance with a risk rating system adopted by the board, (2) evaluates credit administration and provides for prompt correction of deficiencies, and (3) reports on the results of the ongoing review process to management and directors. The ongoing program of internal credit review should accurately assess risk in the institution at all times. Periodically, the board should commission a comprehensive independent review of credit to test the reliability of the internal credit review process. An independent review allows for an objective assessment of the portfolio by qualified people who are not responsible for credit decisions and who, for this purpose, report directly to the board.

External audits: An outside audit of the institution's financial and accounting records is essential to maintaining integrity in accounting systems. Typically, the board contracts with an accounting firm to perform the outside audit. The scope of the audit should be sufficient to enable the accounting firm to produce an unqualified opinion on the institution's financial and accounting records assuming one is warranted.

Asset/Liability Management (ALM)

The ALM process is the act of planning, acquiring, and directing the flow of funds through an institution. The ultimate objective of this process is to generate adequate stable earnings and equity, while taking reasonable and measured business risks. The safe and sound operation of a financial institution depends on management's ability to measure and manage risks efficiently.

The management of interest rate risk (IRR) is a critical element of a board's ALM policy. To facilitate the ALM process, the board should implement an ALM policy that results in adequate/stable earnings and an appropriate amount of equity under alternative operating environments. This should typically include the following specific items:

- Description of the ALM decision-making process and delegations of authority.
- Explicit limits on IRR.
- Off-balance-sheet authorizations and parameters.
- Monitoring procedures, internal controls, and reporting requirements.

Directors should assure themselves through policies that exposure of earnings and capital to potential interest rate movement is considered and measured prior to making business decisions. In addition, directors must always remember that they are ultimately accountable for all activities of the institution, including the effective management of interest rate risk, even when other organizations (such as the funding bank) may perform activities integral to managing that risk. The principles of effective management in this area are complex. The board should not hesitate to obtain outside expertise, if necessary, to learn about the principles of IRR management and to ensure that all of the institution's officers and staff understand these principles as well.

Earnings

A stable and well-managed income stream that is insulated from risks in the operating environment is essential for the stability of a healthy lending institution. The board's policy for earnings should establish the basis on which the institution will maintain its financial condition and performance. The board must consider the risks in the operating environment, as well as the institution's earnings and capital objectives, when it establishes the operating standards for management. The earnings policy should address the composition of earnings that management is expected to achieve and the interest rate programs available to achieve them. The established parameters for managing interest rates should address margins, competition, and profitability of portfolio segments. Earnings must sufficiently cover all operating costs, augment capital growth, maintain adequate reserves, generate an acceptable return on assets, and provide for contingencies.

Liquidity

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 expected and/or unexpected balance sheet fluctuations and to provide funds for growth.

The board's policy for liquidity management should consider the objectives to be accomplished and the parameters within which management should operate. The principal sources of funding and liquidity for a bank are capital markets available through the Federal Farm Credit Banks Funding Corporation. Secondary sources of liquidity are obtained through investment management in accordance with FCA regulations. Tertiary sources may be secured with 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. Therefore, the board must ensure that the association honors standards established for access to funding. Failure to comply with the terms of general financing agreements could result in additional fees, penalties, increased interest costs, or suspension of funding. Each of these consequences could increase the cost of maintaining liquidity to the association and ultimately the cost to borrowers. The board must carefully measure and monitor the institution's liquidity position to ensure that operations are not disrupted because of inadequate funding.

Allowance for Losses

System lending institutions are required to maintain an adequate allowance for loan losses at all times. The allowance may include reserves for specific loans, groups of loans, categories of loans, risk classifications, concentrations, or general risks in the lending environment. The allowance serves as an indicator of the amount of loss risk in the loan portfolio and, as such, is extremely important to shareholders and investors. It is equally important, therefore, that board members understand the heavy obligation they have for ensuring that the proper amount is maintained in the reserve and reported publicly in the institution's financial reports. To ensure that an adequate allowance is maintained, the board's policy should include a periodic review and adjustment of the allowance as circumstances dictate. Most lending institutions should perform a quarterly analysis in accordance with generally accepted accounting principles. Sometimes, however, a more frequent analysis is needed, particularly if risks are changing in an abnormal manner. The review process should substantiate the methodology or basis on which the allowance was determined.

Directors (individually and collectively) are ultimately responsible for ensuring that the institution maintains an adequate allowance for loss risk. They need not be accounting experts, but they are expected to be familiar with the institution's operating environment and business activities, to question the adequacy of the allowance, and to call for outside expertise if any doubts exist about the allowance.

APPENDIX B– Key Financial Ratios

The following ratios constitute some of the more important financial indicators that may assist a board of directors in following the financial progress of their institution. For further information, the FCA's publication "Guide for the use of the UNIFORM PERFORMANCE REPORT and the UNIFORM PEER PERFORMANCE REPORT" is highly recommended.

- ***Return on Average Assets:*** Net income divided by average assets. Measures how efficiently the institution uses its assets to generate earnings.

- ***Net Interest Margin:*** Interest income less interest expense divided by average earning assets. Reflects funding costs, loan pricing, and investment practices.

- ***Operating Expenses to Average Earning Assets:*** Total operating expenses divided by average earning assets. Measures the operating efficiency relationship between the operating costs and the assets producing earnings.

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

- ***Permanent Capital to Risk Adjusted Assets:*** Permanent capital (as defined by the Act) divided by risk adjusted assets. Indicates capital available to support assets and fund future growth.

- ***Adverse Assets to Risk Funds:*** Compares the risk in the loan portfolio and other property owned to the institution's permanent capital base plus its allowance for losses on loans. Measures the risk-bearing capacity and threat to the institution's capital base presented by the quality of assets.

- ***High Risk Assets to Total Assets:*** Loans that are at least 90 days past due, have been restructured, or are in nonaccruing status, and other property owned divided by total assets. Indicates the quality of assets and effects on asset profitability.

- ***Allowance for Losses to High Risk Assets:*** The allowance for losses is an estimate of probable losses and impairment of the loan portfolio. The allowance for losses is divided by high risk assets to measure the ability to absorb losses from assets identified as having high exposure to loss.

APPENDIX C– Laws and Regulations Covering Conflicts of Interest

Noted below are certain sections of the Act and its implementing regulations that focus on director conflicts of interest and disclosure requirements. Directors should become thoroughly familiar with the provisions.

12 C.F.R. Part 612 addresses the conduct of directors and director disclosure of business transactions. The regulations require directors to maintain high standards of industry, honesty, integrity, impartiality and conduct; describe prohibited director and employee conduct; require directors and employees to disclose their own business transactions with the institution as well as those of family members and close associates; and mandate other financial disclosures necessary for the Annual Report to Shareholders. The regulations stipulate that the board of directors must establish policies and procedures governing standards of conduct for directors and employees that are consistent with the regulations and that the board designate a Standards of Conduct Officer.

12 C.F.R. 620.5(j) addresses the disclosure requirements in the Annual Report to Shareholders on transactions with senior officers and directors.

In addition, criminal penalties under Title 18 of the United States Code may be faced by directors for such matters as the following:

- Making loans or offering gratuities to FCA examiners. **(18 U.S.C. § 212)**
- Receiving a commission or gift for procuring a loan. **(18 U.S.C. § 215)**
- Misapplying funds. **(18 U.S.C. § 657)**
- Making false entries in the institution's books, reports, or statements; or issuing or assigning notes, bonds, debentures, or other obligations or mortgages without authority. **(18 U.S.C. § 1006)**
- Misrepresenting the character, security conditions, or terms of bonds. **(18 U.S.C. § 1013).**
- Making false statements in a loan application**. (18 U.S.C. §1014)**

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Revision-3000 9/97