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Report to the Ranking Minority Member, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate

August 2001

FARM CREDIT ADMINISTRATION

Analysis of Administrative Expenses and Funding Through Assessments

GAO Accountability * Integrity * Reliability

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Contents

Abbreviations

CAMELS	capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk
FCA	Farm Credit Administration
FDIC	Federal Deposit Insurance Corporation
FHFB	Federal Housing Finance Board
FHLBanks	Federal Home Loan Banks
GSE	government-sponsored enterprise
NCB	National Consumer Cooperative Bank
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OFHEO	Office of the Federal Housing Enterprise Oversight
OSMO	Office of Secondary Market Oversight
OTS	Office of Thrift Supervision

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

August 2, 2001

The Honorable Richard G. Lugar
Ranking Minority Member, Committee on
Agriculture, Nutrition, and Forestry
United States Senate

Dear Senator Lugar:

This report responds to your December 6, 2000, request that we provide information on the annual administrative expenses incurred by the Farm Credit Administration (FCA), the regulator of the Farm Credit System (System). Administrative expenses, which accounted for about 97 percent of FCA's total operating expenses of $34.5 million in fiscal year 2000,[1] are funded primarily by assessments on the institutions that make up the System, including the Federal Agricultural Mortgage Corporation (Farmer Mac). As agreed with your staff, our objectives were to (1) analyze trends in administrative expenses for fiscal years 1996 through 2000 and (2) compare the ways that FCA and other federal financial regulators calculate the assessments they need to fund their operations.

Results in Brief

While FCA's administrative expenditures varied each year between 1996 and 2000, they remained below 1996 levels and stayed within congressionally imposed annual spending limits for each year during 1997 through 2000. (Congress did not set a limit in 1996.) Overall between 1996 and 2000, the agency experienced a decline in administrative spending of around $2 million, or 5.8 percent. As a point of reference, during this same period, the price index for federal government expenditures increased 8.59 percent.[2] Personnel costs (staff salaries and benefits) made up the largest expenditure category, consistently accounting for more than 80 percent of administrative spending; thus, a 15-percent staff reduction also provided the greatest overall savings. Among expenditure categories, equipment and other contractual services accounted for the largest increases over the study period, primarily because of computer upgrades and purchases and the installation of a new financial management system.

[1] The dates used in this report refer to fiscal years.

[2] *Bureau of Economic Analysis's Price Indexes for Gross Domestic Product and Gross Domestic Purchases: Federal Government*, U.S. Department of Commerce (1996-2000).

FCA funds its operational budget in much the same way as the other federal financial regulators included in our study. Unlike many government agencies whose operations are funded by taxpayers' money, the federal financial regulators are self-funded agencies that rely primarily on assessment revenue from the entities they regulate. In calculating these assessments, FCA and the other federal financial regulators use separate methodologies for primary and secondary market entities.[3] For primary market institutions, the regulators, with one exception, apply complex formulas that take into account the size of an institution's asset holdings, findings from annual examinations, and other factors. The assessment costs are applied in increments that decline for institutions with large asset holdings to reflect reduced incremental supervisory costs. Institutions that receive low supervisory examination ratings may also have to pay a surcharge to cover the costs of additional supervision. The formulas for calculating assessments for secondary market entities involve less complex computations that take into account various factors, such as the regulator's direct and indirect expenses or each institution's total assets or capital.

We obtained comments on a draft of this report from FCA officials and officials of the other regulatory agencies included in our study. FCA officials agreed with the information presented in the draft report and provided technical clarifications, which we incorporated where appropriate. FCA's comment letter is reprinted in appendix I. All of the other federal financial regulators, except the Office of Federal Housing Enterprise Oversight (OFHEO), provided technical comments on the draft report, which we incorporated where appropriate. OFHEO did not provide any comments.

We are not making recommendations in this report.

Background

FCA is an independent federal regulatory agency responsible for supervising, regulating, and examining institutions operating under the

[3] Primary market entities are entities that lend directly to borrowers (individuals and/or businesses), provide other financial services to such borrowers, and/or engage in other financial activities. Secondary market entities are entities that buy and sell loans obtained from primary market entities, either individually or in the form of securities backed by cash flows from groups or "pools" of loans.

Farm Credit Act of 1971, as amended.[4] The act also authorizes FCA to assess the institutions it regulates to provide funds for its annual operating costs and to maintain a reserve amount for contingencies, as applicable.[5] FCA regulations allow several methods for FCA to assess and apportion its administrative expenses among the various types of institutions it oversees. These institutions include primary market institutions (banks and associations) and related entities[6] that collectively comprise the System, in addition to Farmer Mac (a secondary market entity). As of September 30, 2000, the System (excluding Farmer Mac) included 172 institutions holding assets of about $91 billion; Farmer Mac's assets were about $3 billion. The System is designed to provide a dependable and affordable source of credit and related services to the agriculture industry.

FCA regulates and examines Farmer Mac, the secondary agricultural credit market entity, through the Office of Secondary Market Oversight (OSMO), which is an independent office with a staff of two within FCA.[7] Figure 1 depicts the regulatory relationships among FCA, OSMO, the System, and Farmer Mac. Farmer Mac was created to provide a secondary market to improve the availability of agricultural and rural housing

[4]12 U.S.C. 2250. Under a separate statute, Congress requires that FCA also annually examine the National Consumer Cooperative Bank (NCB) and its affiliate, NCB Development Corporation. Neither entity is affiliated with the System. These entities reimburse FCA for the cost of their examinations on the basis of direct examination expenses plus an allocated portion of FCA indirect expenses that are reasonably related to the services FCA provided to them.

[5]To determine if any reserves are necessary and the amount of such reserves, FCA would consider the possibility of a major lawsuit outcome or other expenses or activities that could result in an extraordinary increase in annual expenses. FCA officials stated that, to date, the agency has not found it necessary to establish such a reserve.

[6]These related System entities provide services to the System's lending institutions. They include the Farm Credit Leasing Services Corporation; the Farm Credit System Financial Assistance Corporation; the Federal Farm Credit Banks Funding Corporation; the Farm Credit Finance Corporation of Puerto Rico; Farm Credit Financial Partners, Inc.; and any other institution statutorily designated as a System institution that is not a bank or association.

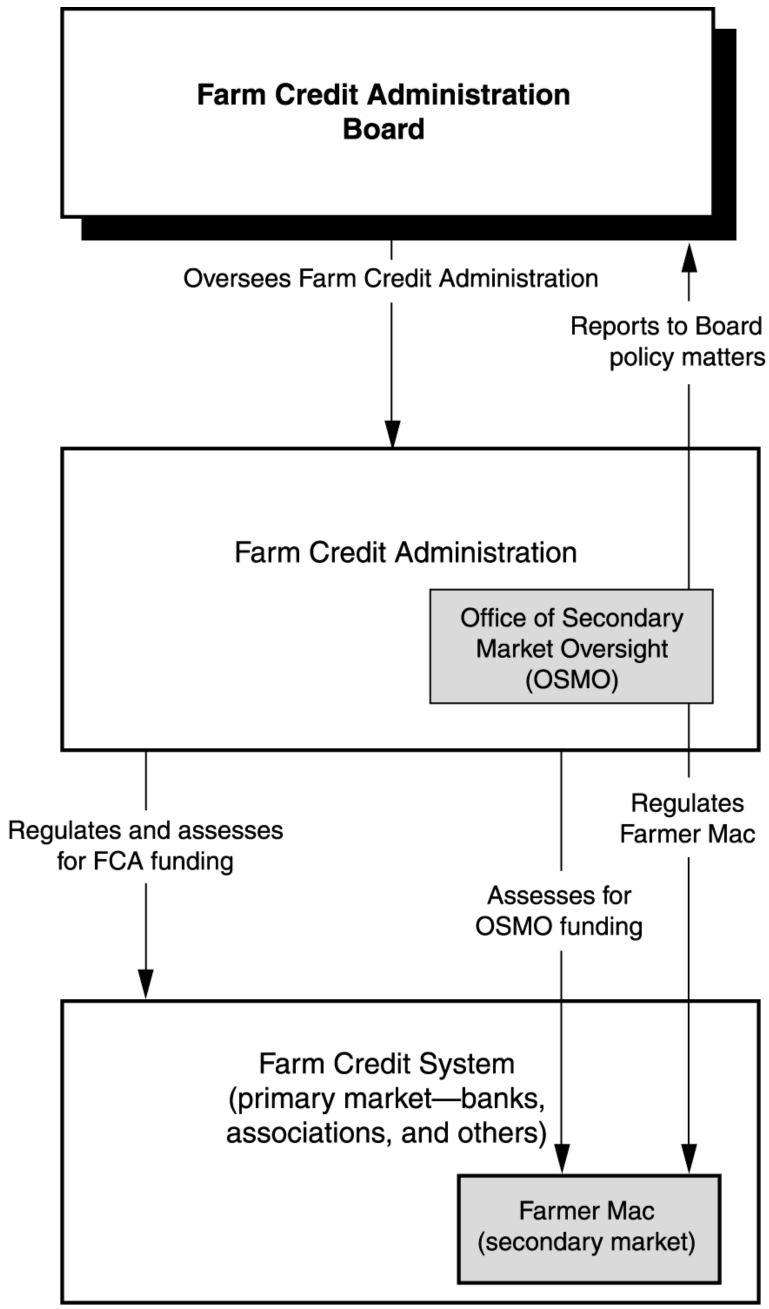
[7]In 1992, OSMO was created as a separate office within FCA, reporting directly to the FCA Board. FCA provides staff resources, for example, examination, legal, and administrative support staff, to OSMO to assist it in regulating and supervising Farmer Mac.

mortgage credit to lenders and borrowers.[8] Both the System and Farmer Mac are government-sponsored enterprises (GSE).[9]

[8]Farmer Mac is organized as an investor-owned corporation. It has no liability for the debts of any other System institution, and other System institutions have no liability for Farmer Mac's debts.

[9]A GSE is a private institution chartered by Congress to serve the purpose of facilitating the flow of funds to a particular sector of the economy, in this case agriculture. For additional information about FCA and Farmer Mac, see *Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems* (GAO/GGD-94-14, Jan. 7, 1994) and *Farmer Mac: Revised Charter Enhances Secondary Market Activity, but Growth Depends on Various Factors* (GAO/GGD-99-85, May 21, 1999).

Figure 1: Flowchart of FCA Regulatory Structure



Note: OSMO reports to the FCA Chief Executive Officer for administrative matters.

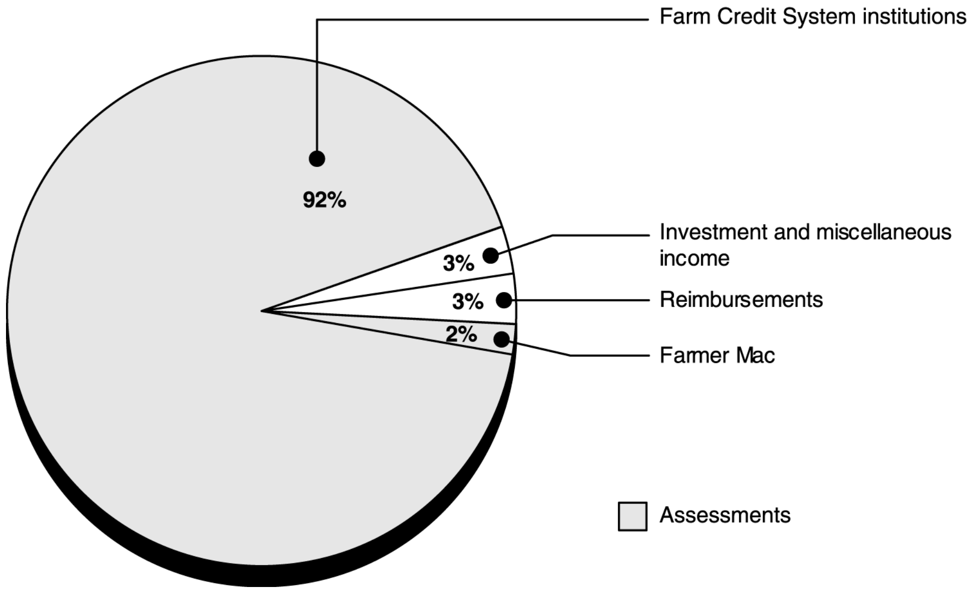
Source: GAO.

Although FCA does not receive any funds from the U.S. Treasury for its operating budget, its annual budget is subject to the annual congressional appropriations process, which limits the dollar amount that the agency can spend on administrative expenses. For 2000, that amount was $35.8 million. FCA raises operating funds from several sources, but most of these funds are from assessments on the institutions that it regulates. Assessments accounted for about 94 percent (including 2 percent for Farmer Mac) of the funding for the FCA's 2000 operating budget, with the balance coming from reimbursable services, investment income, and miscellaneous income (see fig. 2). FCA officials define administrative expenses as generally comprising personnel compensation, official travel and transportation, relocation expenses, and other operating expenses necessary for the proper administration of the act.[10] FCA also has reimbursable expenses, which include the expenses it incurs in providing services and products to another entity.[11]

[10]FCA officials also noted that expenses are categorized by the classifications specified in Section 83 of the Office of Management and Budget's Circular A-11, Preparation and Submission of Budget Estimates.

[11]According to FCA's Chief Financial Officer, the agency has two types of reimbursable expense services—those mandated by statute and those performed under contractual agreements. For example, FCA's annual examination of NCB is a statutory reimbursable expense, but its examination of the Small Business Administration's Specialized Business Lending Companies is contractual. For 2000, FCA had reimbursable expenses of about $1.1 million, or 3 percent of its total operating expenses.

Figure 2: FCA Sources of Revenue, Fiscal Year 2000



Source: GAO analysis of FCA-provided data.

The five other federal financial regulators discussed in this report have oversight responsibility for various types of institutions.[12] Table 1 shows these regulators, along with the types of institutions that they regulate.

[12]We did not include the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) in this study because they do not charge for examinations. The Federal Reserve, in cooperation with state regulators, examines state-chartered Federal Reserve member banks. The Federal Reserve funds its operations primarily through income on investments and payments received from the banking industry for services provided to the industry. FDIC, in cooperation with state regulators, examines state-chartered nonmember Federal Reserve banks. FDIC funds its operations primarily through insurance premiums and the investment income derived from these premiums.

Table 1: Other Federal Financial Regulators and the Types of Institutions That They Regulate

Regulator	Type of regulated institution
Federal Housing Finance Board (FHFB)	**Primary market institutions**. Federal Home Loan Banks[a]
National Credit Union Administration (NCUA)	**Primary market institutions**. Federal credit unions and state-chartered credit unions that are federally insured; oversees and administers the National Credit Union Share Insurance Fund
Office of the Comptroller of the Currency (OCC)[b]	**Primary market institutions.** National banks and federal branches and agencies of foreign banks operating in the United States
Office of Thrift Supervision (OTS)[b]	**Primary market institutions**. Federally chartered thrifts and federally insured state-chartered savings associations and savings and loan holding companies
Office of Federal Housing Enterprise Oversight (OFHEO)[c]	**Secondary market entity**. Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)[a]

[a]These entities are GSEs.

[b]OCC and OTS are independent entities within the Department of the Treasury.

[c]OFHEO is an independent entity within the Department of Housing and Urban Affairs.

Source: GAO.

For purposes of comparison, we group the regulators into two categories according to the types of market primarily or exclusively served by the institutions they regulate, primary and secondary market entities. Of the five regulators, four—FHFB, NCUA, OCC, and OTS—regulate primary market institutions. OFHEO regulates secondary market entities. FHFB regulates the 12 Federal Home Loan Banks (FHLBanks) that lend on a secured basis to their member retail financial institutions. Under certain approved programs and subject to regulatory requirements, the FHLBanks also are authorized to acquire mortgages from their members.

By law, federal financial regulators are required to examine their regulated institutions on a periodic basis (e.g., annually). The primary purpose of these supervisory examinations is to assess the safety and soundness of the regulated institution's practices and operations. The examination process rates six critical areas of operations—capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and sensitivity to market risk (S), or CAMELS.[13] The rating system uses a 5-point scale (with 1 as the best rating and 5 as the worst rating) to determine the CAMELS rating that describes the financial and management condition of the institution. Examiners issue a rating for each CAMELS element and an overall composite rating. The results of an examination, among other things, determine the extent of ongoing supervisory oversight.

To varying degrees, the regulators also have responsibility for ensuring their institutions' compliance with consumer protection laws. Moreover, two GSE regulators (FCA and FHFB) have responsibilities for ensuring compliance with their respective GSEs' statutory missions. Mission and safety and soundness oversight for Fannie Mae and Freddie Mac are divided. The Department of Housing and Urban Development has general regulatory authority over Fannie Mae and Freddie Mac to ensure compliance with their missions, while OFHEO has the authority for safety and soundness regulation.

Scope and Methodology

To meet the first objective, we examined agency budget reports and financial documents and interviewed FCA and Farmer Mac officials. We compared FCA's reported actual administrative expenses (total operating expenses less reimbursable costs) with congressionally imposed limits; reviewed relevant statutes, legislative history, FCA regulations, and FCA legal opinions; and developed a 5-year trend analysis.

To address the second objective, we interviewed agency officials, reviewed relevant statutes and regulations, and analyzed data on operational funding obtained from FCA and the five other federal financial regulatory agencies. We selected these five agencies because they use funding mechanisms that are similar to FCA's to support their operating budgets. We did not independently verify the accuracy of the data that the regulators provided or review any agency's accounting records.

We obtained comments on a draft of this report from FCA and the five other federal financial regulatory agencies. FCA's comments are

[13]FCA refers to this rating system as the Financial Institution Rating System. NCUA uses a CAMEL rating system but presently does not have a separate rating for market sensitivity (the "S" component). The regulators for Farmer Mac, Fannie Mae, and Freddie Mac and the FHLBanks do not use a CAMELS rating system due to the small number of institutions regulated. However, they do use categories that classify the level of supervisory concern of examination findings.

summarized at the end of this report. Except for OFHEO, all agencies provided technical comments, which we incorporated as appropriate.

We conducted our work from January to July 2001 at FCA headquarters in McLean, VA, and at the headquarters of the other five regulators in Alexandria, VA, and Washington, D.C. We conducted our review in accordance with generally accepted government auditing standards.

FCA Administrative Expenses Fell Modestly From 1996 Through 2000, Remaining Within Congressionally Imposed Limits

Over the last 5 years, FCA has reduced expenditures for administrative expenses, reflecting the agency's success in controlling operating costs. Staff reductions—due, in part, to consolidation within the System—have accounted for most of the decline in administrative expenditures. While actual administrative expenditure amounts have varied from year to year, FCA has continued to operate below congressionally approved spending levels.

FCA Administrative Expenses Were Lower in 2000 Than in 1996

Significant dollar decreases in personnel costs were largely responsible for the decrease in administrative spending and the 5.8 percent decline compared with the 8.59 percent growth rate in federal government expenditures. Despite increases in purchases of other contractual services and equipment, administrative costs remained below the 1996 level throughout the second half of the 1990s and into 2000 (see table 2). The decline was not spread evenly over the 5-year period (see fig. 3). Most of the decline occurred in 1996-98, and administrative spending has increased each year since then. For 2001, administrative expenditures are expected to rise by $852,000, or 2.6 percent, over their 2000 level, primarily because of rising costs for personnel, travel, and transportation.

Table 2: Changes in FCA Administrative Expenses From Fiscal Years 1996-2000, by Expense Category

Dollars in thousands

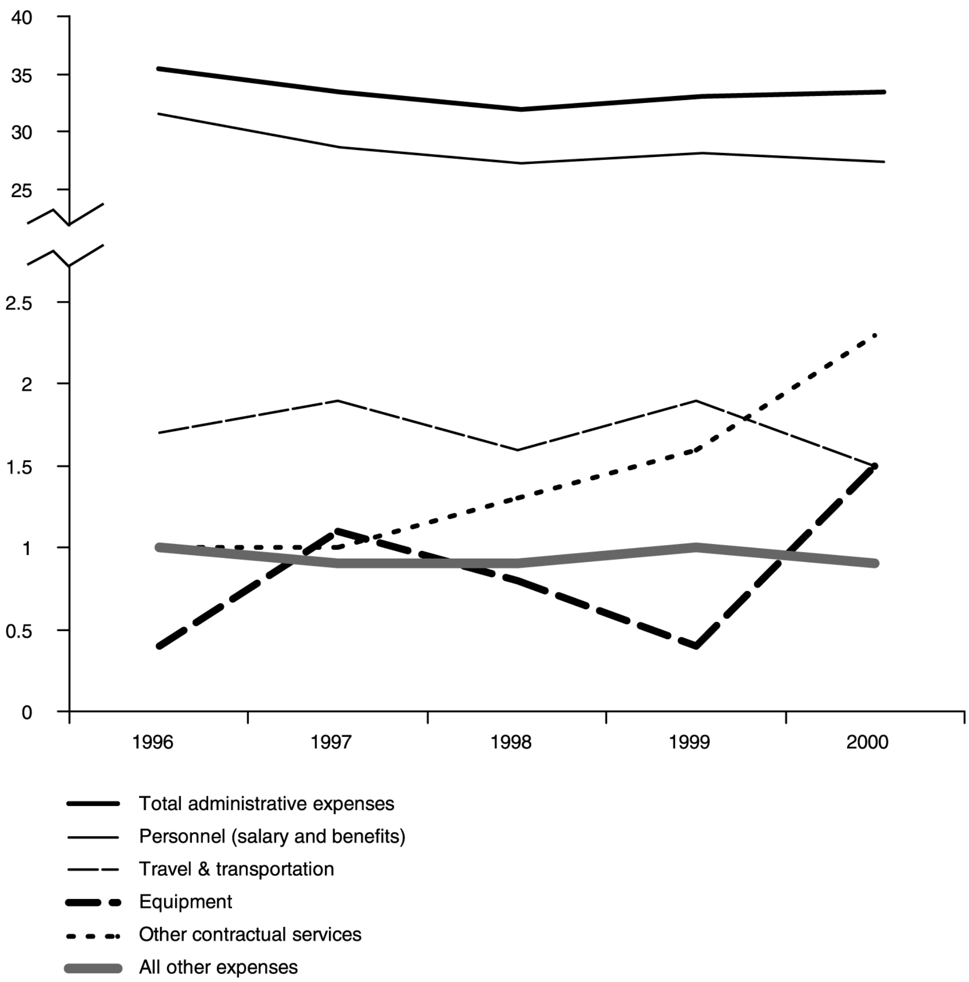
Expense category	Fiscal Year 1996	Fiscal Year 2000	Dollar increase/(decrease) from fiscal year 1996	Percentage increase/ (decrease) from fiscal year 1996
Personnel costs				
Salary	$24,254	$22,739	($1,515)	(6.2)
Benefits	7,253	4,622	(2,631)	(36.3)
Subtotal	**31,507**	**27,361**	**(4,146)**	**(13.2)**
Travel and transportation	1,675	1,512	(163)	(9.7)
Other contractual services	992	2,275	1,283	129.3
Equipment	395	1,452	1,057	267.6
All other expenses[a]	957	878	(79)	(8.3)
Direct administrative expenses	**$35,526**	**$33,478**	**($2,048)**	**(5.8)**
Plus: Reimbursable Expenses	251	1,051	800	318.7
Total operating expenses	**$35,777**	**$34,529**	**($1,248)**	**(3.5)**

Note: The price index for federal government expenditures increased 8.59 percent for the period of 1996 to 2000.

[a]All other expenses include rent, communications, and utilities; printing and reproduction; supplies and materials; and insurance claims.

Source: GAO analysis of FCA-provided data.

Figure 3: Trends in FCA Administrative Expenses, Fiscal Years 1996-2000 (Dollars in millions)



Source: GAO analysis of FCA-provided data.

Our analysis of FCA data shows that personnel costs accounted for over 80 percent of the FCA administrative expenses during the 5-year study period.[14] But these costs (staff salaries and benefits) also decreased the most in dollar and percentage terms during the period, falling by about $4.1 million (13 percent), and the share of personnel costs in

[14]Personnel costs also represent a high percentage (55 to 78 percent for the year 2000) of the operating expenses at the five other federal financial regulatory agencies, generally due to the labor intensiveness of supervision.

administrative expenditures fell from 88.7 percent to 81.7 percent. Reductions in benefits were largely responsible for this decline; the amount spent on staff benefits dropped 36.3 percent, falling from $7.3 million in 1996 to $4.6 million in 2000. Decreases in the relocation allowances, severance pay, and buyouts necessitated by the consolidation of the System accounted for most of the decline. FCA officials told us that the number of employees fell almost 15 percent—from 331 in 1996 to 282 in 2000—in part, because of the industry consolidation. The number of institutions in the System dropped by 28 percent, declining from 239 in 1996 to 172 in 2000. For 2001, however, FCA projects personnel costs to increase by 5.3 percent to about $28.8 million. As a result, our analysis shows that these costs will continue to account for a substantial percentage of administrative costs. FCA officials attribute the increase to the rising cost of employee salaries and performance bonuses.

Equipment purchases and other contractual services accounted for the largest increases in administrative expenditures in 1996 through 2000. Equipment purchases experienced the largest growth but fell behind contractual services in actual dollar increases. Equipment purchases rose about $1.1 million (from $395,000 in 1996 to $1.5 million in 2000), which was about a 268-percent increase over 1996. According to an FCA official, computer replacements and upgrades, which the agency undertakes every 3 years, accounted mostly for the increase. FCA officials expect equipment purchases to decline $202,000, or about 14 percent, in 2001.

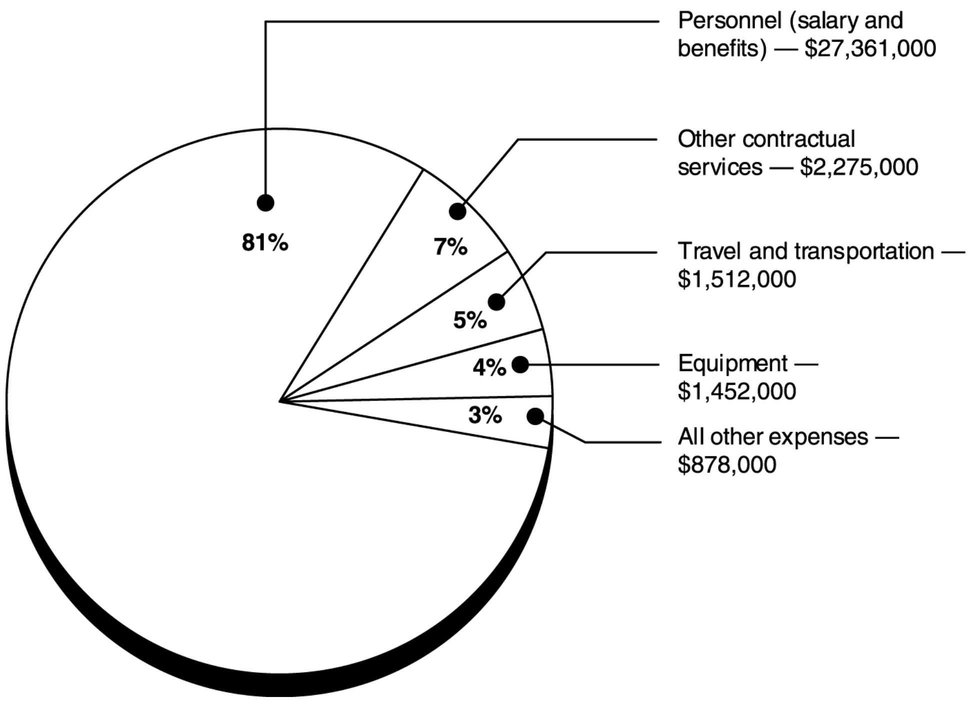
Other contractual services represented a growing percentage of FCA administrative costs, increasing from 2.8 percent in 1996 to 6.8 percent of the 2000 total. These expenses consisted mostly of consulting services for a new financial management system purchased from another government agency. They accounted for the largest dollar increase (about $1.3 million) and the second-largest percentage increase (about 130 percent) in administrative expenditures, climbing from $992,000 in 1996 to $2.3 million in 2000. For 2001, however, FCA expects this cost component to decline by $209,000, or 9.2 percent.

Travel and transportation expenses declined (by about 10 percent) between 1996 and 2000. FCA officials told us the decrease was largely the result of a decline in the number of employee relocations. For 2001, FCA projects these costs to decrease by $231,000, or about 15 percent.

All other expenses, a category that includes rent, communications, and utilities; printing and reproduction; supplies and materials; and insurance claims and indemnities, decreased by $79,000, or 8.3 percent, over the period, primarily because of decreases in supplies and materials. For 2001, FCA expects these costs to increase by 4.3 percent.

Figure 4 shows FCA administrative expenses for 2000 by expense category.

Figure 4: FCA Administrative Expenses, by Expense Category, Fiscal Year 2000



Source: GAO analysis of FCA-provided data.

Actual FCA Administrative Expenses Did Not Exceed Congressionally Authorized Spending Levels

Each fiscal year, Congress sets a limit on the amount of money FCA can spend on administrative expenditures. However, Congress did not set a spending limit for 1996. For each year from 1997 to 2000, FCA was in compliance with its budget limits for administrative expenses (see table 3).

Table 3: FCA Administrative Expenses, Congressional Ceilings and Actual Expenditures, Fiscal Years 1996-2000

Dollars in thousands

Fiscal year	Congressionally authorized spending level (ceiling)	Actual FCA administrative expenses	Amount under ceiling	Percentage under ceiling
1996	N/A	$35,526	N/A	N/A
1997	$37,478	33,506	$3,972	10.6
1998	34,423	31,934	2,489	7.2
1999	35,800	33,111	2,689	7.5
2000	35,800	33,478	2,322	6.5

Legend: N/A = not applicable

Source: GAO analysis of FCA-provided data.

FCA Calculates Its Assessments in Much the Same Way as Other Federal Financial Regulators

FCA and the other federal financial regulators do not receive any federal money to fund their annual operating budgets, relying primarily on assessment revenue collected from the institutions they oversee. In general, the regulators assess institutions using either complex asset-based formulas or less complex formulas that are based on other factors, depending on the type of institution. The different funding methodologies are designed to ensure that each institution pays an equitable share of agency expenses.

FCA uses two different methods of calculating assessments on the institutions it regulates—one for all primary market entities and the other for its secondary market entity, Farmer Mac. The methodology used for primary market entities, which is complex, is based on the institutions' asset holdings and economies of scale as well as on the supervisory rating each institution received during FCA's last periodic examination. [15] The methodology used for Farmer Mac is less complex. FCA calculates the assessment on the basis of its own direct and indirect expenses, rather than on asset holdings. Direct expenses include the costs of examining and supervising Farmer Mac, while indirect expenses are the overhead costs "reasonably" related to FCA's services. In general, the other federal

[15]Economies of scale are based on the notion that the average cost of a good or service falls as production increases. In this case, an economy of scale exists for larger institutions because a relatively small number of regulatory staff can oversee large amounts of assets. FCA uses declining marginal rates in its assessment computation to account for such supervisory cost savings.

financial regulators that regulate institutions similar to FCA's use comparable methodologies to calculate assessments.

The FCA Formula for Assessing Primary Market Entities Considers Assets, Marginal Costs, and Financial Performance as Well as FCA's Funding Needs

The law requires that the assessments be apportioned "on a basis that is determined to be equitable by the Farm Credit Administration."[16] FCA's current assessment regulations for banks, associations, and "designated other System entities" were developed in 1993 through the negotiated rulemaking process.[17] Banks, associations, and the Farm Credit Leasing Services Corporation (Leasing Corporation) are assessed on the same basis (i.e., assets). According to an FCA official, the agency periodically reviews these rules but currently has no plans to modify them. FCA officials said that these rules are designed to equitably apportion the annual costs of supervising, examining, and regulating the institutions. For this reason, the methodology relies on asset "brackets" that are much like tax brackets and reflect economies of scale, since the costs of supervision rise as a regulated institution becomes larger; however, these costs do not increase as fast as asset growth. FCA "bills" the institutions annually, and the institutions pay their assessments on a quarterly basis.

To calculate the assessments for banks, associations, and the Leasing Corporation, FCA first determines its annual operating budget, which could include a reserve for contingencies for the next fiscal year, then deducts the estimated assessments for Farmer Mac, other System entities, and any reimbursable expenses. What is left—the net operating budget—is the total amount that will be assessed. This amount is apportioned among the banks, associations, and the Leasing Corporation using a two-part formula. The net operating budget is divided into two components of 30 and 70 percent. (According to an FCA official, the 30/70 split was devised during the negotiated rulemaking process and represents the most equitable way to assess System institutions.) The first part of the assessment, covering 30 percent of the budget, is spread across institutions on the basis of each institution's share of System risk-adjusted assets.[18] For example, an institution whose assets equal 1 percent of

[16]12 U.S.C. 2250(a)(2)(A).

[17]Currently, the only "designated other System entities" is the Farm Credit Leasing Services Corporation. It is included in this category because, according to FCA officials, its assets are considered similar to those of System banks and associations.

[18]Risk-adjusted assets have been weighted for the risk they entail. For example, an unsecured loan would entail more risk than a mortgage, which is backed by real property.

System assets will have its assessment equal to 1 percent of this 30 percent of the FCA budget. The second part of an institution's assessment is charged according to a schedule that imposes different assessment rates on assets over specified levels, with these marginal rates decreasing for higher levels of assets. For example, the assessment rate that an institution pays for its assets from over $100 million to $500 million is 60 percent of the assessment rate that it pays on its first $25 million in assets. Adding the 30-percent amount and the 70-percent amount together equals the general assessment amount.[19] Table 4 shows the assessment rates for the eight-asset "brackets." The assessment rates percentages are prescribed by FCA regulation.

Table 4: FCA Assessment Schedule

Dollars in millions

Average risk-adjusted asset size range		Assessment rate
Over:	To:	
$0	$25	1.00X
25	50	.85 X
50	100	.75 X
100	500	.60 X
500	1,000	.50 X
1,000	7,000	.35 X
7,000	10,000	.20 X
10,000	-	.10 X

Source: Farm Credit Administration.

The general assessment may be subject to these adjustments: a minimum assessment fee, a supervisory surcharge, or both. The minimum fee of $20,000 applies only to institutions whose assessments are calculated at less than $20,000; these assessments are scaled upward, and no further charges are assessed. For institutions with assessments of more than $20,000, FCA may add a supervisory surcharge that reflects the institution's financial and management conditions. The surcharge is based on the institution's last supervisory examination rating. These ratings range from a high of 1 to a low of 5; a rating of 3, 4, or 5 can result in a surcharge ranging from 20 to 40 percent of the general assessment

[19]The general assessment amount is the amount that an institution would pay before any kind of adjustment (e.g., a premium via a supervisory surcharge to cover increased supervision costs).

amount. The top-rated institutions (those rated 1 or 2) pay nothing over the general assessment.

The variables in the formula allow FCA some flexibility in adjusting assessments to reflect its oversight costs. The formula not only reflects economies of scale but, by linking assessments with the financial and managerial soundness of the institutions, also seeks to ensure that the institutions that cost the most to supervise are paying their share. This approach relieves other entities within the System of bearing the cost of this additional oversight. FCA may adjust its assessments to reflect changes in its actual annual expenses and, if applicable, give institutions a credit against their next assessment or require them to pay additional assessments. Any credits are prorated on the basis of assessments paid by an institution. These credit adjustments are usually done at the end of the fiscal year.

FCA Assesses Farmer Mac Using a Less Complex Formula That Is Based on Direct and Indirect Costs

As required by law, FCA assesses Farmer Mac separately and differently from its primary market institutions. The law specifies that FCA's assessment of Farmer Mac is intended to cover the costs of any regulatory activities and specifically notes a requirement to pay the cost of supervising and examining Farmer Mac.[20] We could not identify any legislative history that addressed these provisions. FCA officials told us that they believed the difference between the statutory provisions for assessing banks, associations, and the Leasing Corporation and Farmer Mac is due to the difference in their assets—that is, unlike those institutions, Farmer Mac does not make loans. FCA developed the current assessment methodology for Farmer Mac in 1993.

Farmer Mac's assessment covers the estimated costs of regulation, supervision, and examination, but Farmer Mac is not assessed a charge for FCA's reserve. The assessment includes FCA's estimated direct expenses for these activities, plus an allocated amount for indirect or overhead expenses. In general, FCA uses the same estimated direct expenses and indirect expense calculations for Farmer Mac as for the "other System entities," such as the Federal Farm Credit Banks Funding Corporation (Funding Corporation).[21] Estimated direct expenses take into account the costs incurred in the most recent examination of Farmer Mac and any

[20] 12 U.S.C. 2279aa-11(d) and 2250(a)(C).

[21] The Funding Corporation is the entity that manages the sale of Systemwide debt securities to finance the loans made by System institutions.

expected changes in these costs for the next fiscal year. We asked FCA officials if and how the assessment formula they use for Farmer Mac enables them to compensate for risks in Farmer Mac's business activities. They explained that the amount assessed for direct expenses increases if additional examination time is needed. FCA officials also noted that, as their data show, direct costs can rise due to other factors. For example, from 1999 to 2001, FCA officials noted that they invested considerable resources in developing a risk-based capital rule for Farmer Mac. During this time, FCA incurred unique costs that increased Farmer Mac's assessment for those years.

A proportional amount of FCA's indirect expenses—that is, those expenses that are not attributable to the performance of examinations—is allocated to Farmer Mac. This amount is calculated as a relationship between the budget for a certain FCA office and FCA's overall expense budget for the fiscal year covered by the assessment. (The proportion for 2000 was 28.9 percent.) Multiplying the percentage by the estimated direct expenses attributable to Farmer Mac equals the amount of indirect expenses. The addition of the estimated direct expenses and indirect expenses equals the estimated amount to be assessed Farmer Mac for the fiscal year. Indirect expenses would include, for example, the cost of providing personnel services and processing travel vouchers for OSMO. At the end of each fiscal year, FCA may adjust its assessment to reflect any changes in actual expenses.

FCA Assesses Other Entities in the Farm Credit System Much Like It Assesses Farmer Mac

Other entities in the Farm Credit System, such as the Funding Corporation, are assessed separately using a methodology similar to the one used for Farmer Mac. The assets of this group of institutions differ from those of the previously discussed entities that FCA regulates. These institutions are assessed for the estimated direct expenses involved in examinations, a portion of indirect expenses, and any amount necessary to maintain a reserve. FCA estimates direct expenses for each entity on the basis of anticipated examination time and travel costs for the next fiscal year. Allocations for indirect expenses are calculated as a percentage of FCA's total budgeted direct expenses (excluding those for Farmer Mac) for the fiscal year of the assessment. As with its assessments of other entities in the System, FCA may adjust its assessments to reflect any changes in actual expenses at the end of the fiscal year.

FCA's Assessment Methods Are Much Like Those of Other Financial Regulators With Similar Institutions

FCA and regulators of similar types of institutions use assessment formulas of varying complexity to assess the institutions they oversee. In general, they use relatively complex formulas for primary market institutions and less complex formulas for secondary market entities.

Primary Market Entities

FCA's method for assessing banks, associations, and the Leasing Corporation, which are all primary market institutions, is similar to most other federal financial regulators (NCUA, OCC, and OTS) that oversee primary market institutions. Most of the regulators use complex formulas that take into account a variety of factors, including the regulator's budget, the institution's asset size and examination rating, and economies of scale (see fig. 5). Like FCA's, these assessments generally include a fixed component that is based on an institution's asset holdings, plus a variable component derived by multiplying asset amounts in excess of certain thresholds by a series of declining marginal rates. The assessment amount may then be adjusted on the basis of various factors—for example, the institution's financial condition. Again like the FCA's methodology, these formulas attempt to allocate regulatory costs in a way that reflects the agency's actual cost of supervision. Institutions with a low examination rating pay an additional fee because they are likely to require more supervision than the top-rated institutions. NCUA and FHFB are the only regulators of primary market institutions that do not add a supervisory surcharge on the basis of an examination rating. However, NCUA does use a complex formula to determine an institution's assessment amount, whereas FHFB uses a less complex formula. FHFB calculates assessments for the 12 FHLBanks on the basis of each bank's total paid-in capital stock, relative to the total paid-in capital stock of all FHLBanks.[22]

[22]FHFB also oversees the fiscal agent for FHLBanks, the Office of Finance. It does not, however, assess the Office of Finance. Rather, oversight cost is recovered through assessments paid by the FHLBanks.

Figure 5: Comparison of Factors Used in Assessment Calculations by Regulators

Entity type/ Regulator	Institution's total assets	Institution's examination rating	Condition of insurance fund	Complexity of institution's portfolio	Reflect economies of scale in oversight	Insured deposits	Inflation
Primary market entities							
FCA	●[a]	●			●		
OTS	●	●		●[b]	●		●[c]
OCC	●	●		[d]	●		●
NCUA	●		[e]		●	[e]	
FHFB	FHFB assesses its primary market entities on the basis of a capital contribution ratio.						
Secondary market entities							
OFHEO	OFHEO assesses its secondary market entities on the basis of an asset contribution ratio.						
FCA	FCA assesses its secondary market entity on the basis of estimated direct expenses and indirect expenses.						

Note: All regulators consider their agency's annual operating budget and other sources of funding in determining the total amount that needs to be assessed against their regulated entities.

[a]Risk-adjusted total assets.

[b]Off-balance sheet assets and liabilities: loans serviced for others, trust assets administered, recourse obligations, or direct credit substitutes.

[c]The OTS assessment regulation does not specifically address inflation; however, OTS has the ability to adjust for factors such as inflation.

[d]For independent trust banks and independent credit card banks.

[e]If necessary and as applicable, federally insured credit unions must also pay an adjustment to keep their share insurance fund capitalized at 1 percent of their insured shares and pay insurance premiums. Capitalization fees and insurance premiums are not used to fund NCUA's operations.

Sources: Agency interviews and GAO review of agency assessment regulations.

FCA is the only primary market regulator that requires its institutions to pay a fixed minimum assessment amount (i.e., $20,000).[23] Of the five other regulators we looked at, two—NCUA and OTS—reduce the assessments for qualifying small institutions. According to the report of the Assessment Regulations Negotiated Rulemaking Committee that developed the rule,[24]

[23]OCC, as of January 2001, began charging independent (i.e., not affiliated with a full-service national bank) trust banks a minimum assessment amount. These specialized financial institutions represented 2.2 percent of the banks that OCC regulated at year-end 2000. As of June 2001, OCC began charging independent credit card banks a minimum assessment amount.

[24]*Report of the Assessment Regulations Negotiated Rulemaking Committee to the Farm Credit Administration*, 1992.

the minimum assessment is required both to pay a share of FCA regulatory costs and as a necessary cost of doing business as a federally chartered System institution.

Secondary Market Entities

The assessment methods of the two federal regulators that oversee secondary market entities are less complex than the methods applied to primary market institutions. For example, OFHEO's method of assessing Fannie Mae and Freddie Mac, which is prescribed by law, is based on the ratio of each entity's assets to their total combined assets. OFHEO does not regulate any other entities; thus, this simple formula readily meets the need to equitably apportion the agency's operating costs.

Conclusions

FCA administrative expenditures were lower in 2000 compared with 1996, due in part to reductions in staff because of System consolidation. Although administrative expenses are projected to increase for 2001 because of rising personnel and travel costs, they are expected to remain within the congressional spending ceiling.

FCA is unique among federal financial institution regulators because it regulates both primary and secondary market entities. The methods FCA uses to assess the institutions it oversees are analogous to those used by virtually all of the regulators of similar institutions and are based on the types of assets the entities hold. FCA's complex formula for assessing primary market institutions is comparable to the methods used by most regulators of other primary market institutions. These regulators oversee numerous entities of various sizes and complexities, and their complex assessment methods enable them to consider these attributes in assessing for the cost of examinations. The few secondary market entities, which include Farmer Mac, are all assessed using less complex methodologies.

Agency Comments

We received written comments on a draft of this report from the Chairman and Chief Executive Officer of FCA that are reprinted in appendix I. He agreed with the information presented in the draft report regarding FCA's administrative spending between 1996 and 2000. FCA also provided technical comments that we incorporated where appropriate. The other federal financial regulators, except for OFHEO, provided technical comments on a draft excerpt of this report that we shared with them. We incorporated their technical comments into this report where appropriate.

We are sending copies of this report to the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry; the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing and Urban Affairs, the House Committee on Financial Services, and the House Committee on Agriculture; and Michael M. Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration. The report will be available on GAO's Internet home page at http://www.gao.gov.

If you have any questions about this report, please contact me or M. Katie Harris at (202) 512-8678. Joe E. Hunter was a major contributor to this report.

Sincerely yours,

Davi M. D'Agostino
Director, Financial Markets and
Community Investment

Appendix I: Comments From the Farm Credit Administration

Farm Credit Administration

Office of Inspector General
1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4030

July 23, 2001

Ms. Davi M. D'Agostino
Director, Financial Markets and
Community Investment
General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Ms. D'Agostino:

Thank you for the opportunity to review and comment on the General Accounting Office's (GAO) Report entitled **Farm Credit Administration: Analysis of Administrative Expenses and Funding through Assessments**. As stated in the Report, the Farm Credit Administration (FCA or Agency) has experienced a decline in administrative spending between 1996 and 2000 that is well below the price index for federal government expenditures for the same period. We have undertaken, and will continue to identify and implement initiatives that result in improved operating efficiencies in the Agency.

We appreciate the cooperation afforded us by the GAO staff who worked on the Report. Technical comments were provided to GAO separately. If you have any questions, please contact me at (703) 883-4005.

Sincerely,

Michael M. Reyna

Michael M. Reyna
Chairman and Chief Executive Officer

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