

Making Rural Financial Institutions Sustainable

A Guide to Supportive Rules and Standards

A U.S./Republic of South Africa
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About This Guide

Striving to set up successful financial institutions in rural communities anywhere is difficult. In rural communities of developing countries it is a daunting task. Even if a model is tested and proven, start-up funding obtained, and the doubts of government and local officials overcome, there is still the ongoing challenge of keeping such institutions sound and sustainable once they are operating. This guide is intended as a resource to help make rural financial institutions (RFIs) in developing countries successful and sustainable.

The guide is for anyone involved in providing financial services to small farmers, village entrepreneurs, pensioners and others by organizing and strengthening RFIs. You may be an official in the Ministry of Agriculture, Ministry of Finance, or your country's central bank. You may be working to establish new financial services in rural communities or you are a leader concerned with overcoming known weaknesses in a group of existing RFIs. Or you may be an adviser in a technical assistance program aimed at improving the economic well being of the rural poor. This guide is intended to give you a helpful tool.

How does an RFI offer good services and stay in business? By operating on the basis of recog-

nized "best practices" of financial institutions. But what are these best practices and how can they be communicated to a dispersed group of RFIs? This guide will introduce you to a set of rules and standards that have evolved out of more than a hundred years of rural banking in the United States, Western Europe, and other countries around the world. In addition, the guide suggests organizational mechanisms for setting and implementing rules for RFI operations, rules tailored to current conditions in your country.

This is a "how to" manual on designing and establishing a framework of best-practice rules that will help ensure sound, sustainable operations. It identifies critical issues in managing RFIs that are locally owned and controlled and discusses their implications. It poses questions on each issue to help arrive at policies appropriate for your situation. Finally, it provides illustrations of generic rules that address the operating issues.

It is the authors' hope that this guide will help readers take positive steps toward ensuring the safety and soundness of financial institutions for the long-term benefit of rural people.

The Need for Operating Boundaries

A key pillar of a healthy, prosperous economy is a sound financial system. A well managed, successful group of private and public institutions with a consistent record of performance engenders public confidence in both the economy and the nation. It encourages citizens to freely deposit their savings, knowing they will be kept safely and reallocated as interest-bearing loans for productive business ventures. But experience has proven that long-term safety and soundness of financial institutions require that they operate by a common set of constructive rules and within a framework of independent oversight.

The Asian financial crisis of 1997—'99 demonstrated the consequences of poorly balanced, poorly managed, and politically influenced banking systems. After a period of exceptional economic growth with a fourfold increase in household incomes, unemployment soared and incomes dropped largely due to a lack of prudent judgment in the banking systems that was allowed by ineffective supervision and regulation of bank operations and loan portfolios. Savings and loan institutions in the U.S. in the 1980s experienced somewhat similar problems for many of the same reasons.

Any group of financial institutions hoping to attract savings from large numbers of people must establish a durable bond of trust with those “investors.” Sustainable banking relies on public trust. Maintaining customer confidence requires financial institutions to operate within reasonable boundaries that will ensure their continued soundness. Long-term sustainability of a group of RFIs through safe banking practices is greatly enhanced when they operate within a constructive set of rules and a framework of independent oversight.

A supportive system of rules and oversight, however, must be carefully balanced. An overly bureaucratic process that is inflexible, burdensome, and stifles innovation can impose damaging costs. Unproductive oversight requirements may waste precious bank resources. Conversely, a poorly defined and inconsistently applied regulatory framework may open opportunities for reckless behavior, self-dealing, and unreasonable risk.

The purpose of rules and standards is to ensure the safety and soundness of the financial system and maintain the confidence of depositors, borrowers, shareholders, and the general public.

Setting Rules and Standards

Rules and standards for financial institutions can and should provide useful guidelines. Improper, unrealistic regulations not only impose costly burdens on RFIs but may even cause them to fail. How such rules are established and who establishes them, therefore, is critical.

Mechanisms for setting rules and implementing them can be organized many different ways. The organizational design must consider such things as the number and size of RFIs being regulated, availability of financial and staff resources, government support, related trade associations, how other regulatory bodies operate (for commercial banks, credit unions, micro lenders, etc.), and business traditions of the country.

Who will be involved in setting the rules and standards? Rules in some countries are set by one or more government officials. In others, RFI trade associations establish some of the rules. Relying on trade associations to set rules is a form of “self-regulation” and in some situations may work well. In one East European country, rules are established by the central bank, while audits and inspections are carried out by an RFI trade association. In another

country, representatives of government and the RFIs come together as a regulatory board to set the rules. Whatever the structure, it is important for institutions being regulated to have formal, meaningful input when rules are formulated.

Often an issue in organizing a new regulatory body is funding. How will its operations be financed? A practice in some countries is for funds to be assessed through fees from the RFIs. Where RFIs are barely viable, however, this may be an unreasonable burden. In other countries the cost of a regulatory body is a routine expense of the government. An alternative is for the government to provide staff and office space while RFIs incur such expenses as travel, lodging, meeting expenses, training costs, etc. Donor organizations may help finance the oversight function in the early years. In any event, funding must be considered and may influence how the rule-making mechanism is designed.

In short, a regulatory framework for RFIs can be structured many ways and still be effective. The challenge is to gain the cooperation of key parties—the stakeholders—in arriving at an arrangement that will work.

Tasks of an Oversight Body

A regulatory body has four primary functions: (1) establish appropriate rules for RFI operations, (2) communicate the rules to all parties covered by the rules, (3) ensure that the RFIs operate in compliance with the rules, and (4) adjust the rules from time to time as changing conditions require.

Establishing Sound Rules.

Arriving at rules that are constructive and support RFI operations is not a simple task. Supportive rules and standards should shield RFIs from operating in ways that are self-destructive, yet allow the local institutions to operate freely as businesses serving the community. The rules can be viewed as “operating boundaries.” If an RFI operates within the boundaries, it is likely to avoid catastrophic problems that might threaten the institution’s continued existence.

Writing good rules, therefore, requires the involvement of wise leaders who are experienced in financial matters and financial institutions, as well as in the life

and business in the rural community. Most good rule making involves input from a number of people who have expertise in these different areas—government officials, central bankers, representatives (administrators and shareholders) of the RFIs, farm leaders, and rural entrepreneurs.

Communicating the Rules. Once rules have been established they must be communicated to all the parties (RFI administrators, board members, and shareholders) who are expected to comply. A system needs to be devised to disseminate the rules. Will a manual of rules be used and, if so, how will it be designed and updated? Will informational meetings or training sessions be needed to explain the rules and help ensure that they are understood and will be followed? For regulations to be effective, the institutions regulated must know what the rules are and understand how to operate in compliance. This is a responsibility of the oversight body that issues the rules.

Ensuring Compliance. An effective regulatory body must not only set sound operating rules but also must ensure that the RFIs operate according to the rules. This requires some level of ongoing monitoring and, if necessary, enforcement. Monitoring to know if the RFIs are following the rules can be done through reports, audits, and inspections. Enforcement can be achieved in a variety of ways ranging from informal notices to legal actions as authorized under banking and commercial laws.

If a regulatory body is unable to ensure that RFIs comply with the rules in their banking operations, then the rule-making process is a mere paper exercise. The regulatory framework will be ineffective in ensuring the safety and soundness of the institutions.

Adjusting the Rules. Over time, conditions will change. RFIs will become larger, more experienced institutions. Customer needs for financial services will grow. Economic conditions may improve or deteriorate. Such changes will dictate changes in the rules to enable the RFIs to make necessary adjustments in their operations. A set of rules for RFI operations must be considered an adjustable framework that is flexible, responsive to changing conditions, and allows for exceptions.

Supportive Rules and Standards

What are the “best practices” of banking that will help make RFIs sustainable? How can they be identified and codified into supportive rules? Such rules must be established only after careful analysis and consideration of local conditions. A successful set of rules in one country won’t necessarily work in another. But to facilitate sound rule making for rural financial institutions, the following is a set of basic concepts and principles for RFIs or RFI Systems. Following the discussion of each issue are questions to consider and illustrations of generic operating rules.

Business Purpose

An issue that is often overlooked in establishing a policy framework for rural financial institutions is having a clear, agreed-upon business purpose for the institutions. Why are the RFIs in business? What is their purpose? Such questions often are never asked and thus go unanswered because everyone involved assumes that the reason for establishing the RFIs is understood.

A regulatory framework needs at the outset a well-written statement of the broad business objective of the rural financial institutions. The purpose statement gives

direction in organizing the RFIs and in establishing the operating rules and standards. RFIs should be organized and operated to fulfill their purpose. The business objective is the guiding principle, both at the outset and through the years, as RFIs respond to challenges and opportunities. The purpose will be the standard against which success or failure will be measured.

A user-owned and controlled RFI organized on cooperative principles normally operates to maximize services and hold down costs for its members. Such a business objective directs that earnings be used to build capital (make the RFI stronger) and improve or expand services, not maximize returns to shareholders on their investment.

The lack of a business purpose and philosophy can lead to conflict. A regional cooperative bank in Poland in the mid-1990s, for example, came apart because only half of its shareholders were users of the bank and wanted the bank’s resources to be used to improve services. The other shareholders were not users of the bank’s services and wanted to maximize the financial return on their investments. This disagreement on the purpose of the bank led to its downfall.

RFIs in some countries have been appropriated by the national government to carry out government loan programs because the members lost sight of their cooperatives’ original purpose and let the government take control.

When the business purpose of an RFI is clear, definite, and widely accepted, then rules, standards and operating procedures can be designed and implemented to achieve the RFI’s objective.

Determining the Business Purpose
Fundamental questions should be answered to clarify the purpose of rural financial institutions:

- What is the business of the institution? Is it to provide a full range of financial services needed by people in the community? Or is it limited to making loans to farmers and rural entrepreneurs? Is it to be available as a conduit for loans from government, commercial banks, and nongovernment organizations?
- Who will be served by the institution? Will intended users of the RFI include all people in the local community or only farmers and small businesses? Will such institutions provide services to

anyone in the community or only to the people who buy shares and become members?

- Who will own and control the RFI? Will the institution be owned by a few shareholders or all the people who use its services? Will shareholders (members) have real control of the business?
- What is the ultimate objective of the RFI? Why is the rural financial institution in business? Is its mission to provide service to the members or to maximize the financial return on shareholders’ investments? Is its long-range objective to help improve the economic well being of people in the community? Why does the RFI exist?

Statements of Business Purpose

The statement of business purpose must be written for each country or RFI system recognizing current conditions and expectations. The statement should reflect a shared vision of the stakeholders on what the RFIs might become and what benefits they might bring to the users and the community.

Example: Mission: Rural financial institutions will be organized as cooperative businesses, owned

and controlled by people in the community who become member/shareholders, for the purpose of providing modern, efficient financial services at reasonable cost for the economic benefit of the members.

Example: These rural financial institutions will be organized and operated as cooperative businesses for the purpose of providing reliable, low-cost credit to farmers, entrepreneurs, consumers and others in the rural community, tailored to their unique needs. As cooperative institutions, they will be owned and controlled by the users who become members through the purchase of shares in the business.

Adjusting the Purpose as Conditions Change

It is unlikely that the business purpose of RFIs would be changed for many years. It is true that in becoming world-class banks, the rural cooperative banks of Western Europe (Rabobank, Credit Agricole, DG Bank) many years ago outgrew their purpose of only servicing financial needs of rural communities. And it is possible that member/owners of an RFI might decide to convert their cooperative into a shareholder corporation that operates for profit. But this is cited only to illustrate how unlikely it would be

for the business purpose of the RFIs to change. If a group of RFIs is operating successfully within a well-defined framework of operating boundaries, then a need to change the business purpose is unlikely.

Scope of Business

Once the business purpose has been determined, what kinds of RFI activities and services are consistent with that objective? What activities are inconsistent with the business purpose that, if pursued, could become a threat to the institution's survival? Rules on the RFIs' scope of business both authorize and limit the services they can provide and where they can provide them. Rules on the scope of business will, in large measure, define the kinds of institutions that the RFIs will become, as well as the benefits they will provide to their user/owners.

Cooperative banks in Western Europe, for example, have the legislative and regulatory authority to become full-service, international banks competing with the world's largest commercial banks. Cooperative banks and associations in the United States, in contrast, are limited to providing credit to rural borrowers within the country's borders. Rules

governing these RFIs in the U.S. have not authorized them to accept deposits and become full-service institutions.

Micro-finance institutions in many developing countries operate under rules that allow them to make loans to small entrepreneurs but do not permit them to accept deposits. The regulatory framework for credit unions normally enables them to receive deposits and make loans to their members. But credit union funds for making loans are limited to the funds they have available from member deposits. Their rules do not authorize them to become full-service banks in competition with commercial banks.

What financial services should RFIs provide? Accepting deposits and making loans are the most obvious and beneficial services first considered. But will RFIs provide related services? Are they authorized to transfer funds for their members to and from other financial institutions or offer currency exchange? Will they offer various forms of insurance, such as deposit insurance, credit insurance, crop insurance, or other business and personal insurance? Can they offer accounting and record-keeping service? Investment services or leasing?

Rules on scope of service clarify and guide RFIs on what services they can offer their customers and how they should conduct such business. They also determine the kinds of enterprises the RFI can finance or otherwise do business with. The rules may authorize serving (both deposit taking and financing) farmers, entrepreneurs, and consumers, but prohibit serving corporations. How about doing business with government? Rural Credit Cooperatives in China finance both parastatal businesses and local governments, while in most countries such RFI business is prohibited. Limiting the scope of business is a way of controlling the risk exposure of the RFI.

The rules on scope of business also should clarify where the RFIs are authorized to operate. Is an RFI limited to doing business with customers within the village, township, county or province? Or does its national charter authorize it to do business with anyone from anywhere in the country that becomes a member/shareholder? Rules should determine the geographical territory in which an RFI can offer its services.

Writing Rules on the Scope of Business

In considering appropriate rules on the scope of business it is well to consider three basic questions: What? Who? Where?

- **What financial services is an RFI authorized to provide?** These rules define the scope of services an RFI can offer its customers. They also permit or restrict related business activities of the RFI. Can an RFI, for example, take an equity position (own shares) in a business? Can it borrow funds or otherwise incur debt?
- **Who is an RFI authorized to serve or do business with?** Is it permitted to serve individuals, corporations, government agencies, or foreign parties? Can it enter into financial arrangements with commercial banks or other financial institutions?
- **Where is an RFI authorized to do business?** Is an RFI licensed to conduct business only within a defined territory? If so, what is this geographical territory? Can there be exceptions to territorial limits?

Examples of Rules on the Scope of Business

These rules should be written to answer the questions raised above. They should be simple in nature and clearly stated.

- **Example.** An RFI is authorized to provide financial services to any individual who becomes a member/shareholder. It is prohibited from serving or otherwise entering into business with corporations, government agencies, or foreign parties.
- **Example.** An RFI may receive and accept deposits from its members, grant loans to members, and transfer members' funds to and from other financial institutions. It may receive funds from the social security agency for deposit in member accounts. It may borrow funds or receive other services from a local branch of a commercial bank that has been selected as its link bank.
- **Example.** An RFI is authorized to accept as members and provide financial services to individuals who have their permanent residence within the commonly accepted boundaries of the village. Under unusual circumstances and when approved by the

regulatory body, an RFI may accept into membership and subsequently provide services to an individual from outside the village.

Adjusting the RFI Scope of Business

Rules on the scope of business need to be adjusted as conditions change and as the RFIs become more skilled in conducting their business. The number and type of services may be expanded, for example, as the RFIs gain experience and as needs of their members increase. Or it may become important to RFI members that their institutions facilitate government emergency loans needed in the wake of drought, floods, or other difficult situations.

Rules on territories may need adjustment as a result of mergers, technology, or customer consolidation. After 83 years of limiting U.S. cooperative banks and associations to doing business in designated counties and states, new rules are permitting nationwide territories.

Rules on RFI scope of business need periodic review and revision to enable the institutions to adjust to changes in the business world and changes in the financial needs of their user/owners.

Ownership

Ownership of a rural financial institution can take many forms. RFIs can be organized as member-owned cooperatives, credit unions, private companies, trusts, parastatals, mutuals, local or international nongovernmental organizations (NGOs). This guide focuses primarily on user-owned, membership organizations (cooperatives) but the principles, standards and best practices apply to most rural financial institutions.

How Does the Form of Ownership Effect Rules and Standards?

Having a set of rules and standards in place is essential to protect the safety and soundness of any RFI. The language of the rules may vary somewhat to address the type of structure involved, but the intent is the same.

Examples of Rules on Ownership

- The ownership structure of the institution is clearly defined in the RFI's organizational documents (charter, bylaws, articles of incorporation, franchise agreement, etc.).
- The ownership structure is permitted by the laws of the land.
- The institution is properly registered as required by law.

- Members are aware of the ownership structure.
- Member/owners understand and assert their rights and responsibilities.
- The composition of the board of directors fairly and reasonably represents the interests of the members (see Governance section).

Adjusting Ownership Rules as Conditions Change

If the ownership structure of the RFI changes, organizational documents will need to be amended, but the obligations to keep members or investors informed and to operate as prescribed in these documents does not change.

Customers and Members

Rural financial institutions that are user-owned may require customers to be members. An RFI's license or statute normally sets forth who is eligible to become a member and any conditions related to membership. Eligibility factors, for example, may require that an individual reside in a certain locale, be employed in a specified industry or company, or be part of a common interest group. Such requirements are called a "common bond" relationship.

Being a shareholder in a membership organization carries both rights and responsibilities. The rights of an RFI member normally include access to all services the organization offers, such as savings or deposit accounts, loans, insurance and funds transmission. The member also is entitled to receive annual and special meeting notices, financial reports, and to vote on matters submitted to the membership. A member's responsibilities in belonging to a user-owned RFI are just as important as the member's rights and privileges. A user-owned organization exists for the benefit of its members and, in order for it to succeed, the members must support it with their business and their time. Electing a well-qualified board of directors is the most important responsibility of the RFI's members. Members also must abide by the articles of incorporation, bylaws, and policies of the institution. Penalties may be imposed if there are violations.

What Are the Conditions of Membership?

There are two aspects to this question. An RFI will have specific requirements for becoming a member and another set of rules for determining if a member is in "good standing." Requirements for membership may

include a minimum share purchase that becomes the qualifying membership share. The applicant must also meet any "common bond" requirements that exist such as being a resident of the village or town in which the RFI is located or working in a specific industry or business that the RFI serves.

To be in "good standing," a member must obey the RFI's articles, bylaws, and policies as well as keep current in making loan payments. If a member is found in violation, the board, after proper notice, should have the authority to levy monetary fines, suspend, or terminate membership in the RFI. Normally a suspended member would not have access to the services of the institution during the suspension period and would be disqualified from voting on matters submitted to the membership. Reinstatement of membership status occurs when the member becomes current on loans or the period of suspension specified by the board of directors expires.

What Are the RFI's Responsibilities to Its Members?

The RFI is obligated to maintain accurate and timely membership records. This obligation includes keeping members' personal information current, providing

meeting notices in a timely way, and informing members about RFI services.

Examples of Rules on Customers and Members

RFIs should have proper policies and procedures concerning their customers and members. Examples of such rules are as follows:

- Services of the RFI will be available only to members in good standing.
- Membership records must be accurate and current.
- Eligibility requirements are clearly stated in organizational documents and informational literature provided to members and prospective members.
- General and special meeting notices are communicated to members as specified in the organizational documents.

Adjusting Membership Rules

The RFI should periodically review its eligibility and membership requirements in its organizational documents to ensure that they are still appropriate for the people and businesses being served. The character of the service area may have changed and the eligibility criteria may need modification to accommodate these changes. The "common bond" element of a user-owned

institution, however, normally should be preserved. Policies governing what constitutes a member “in good standing” also should be reviewed from time to time.

Profit Distribution

At the outset, rural financial institutions usually have little concern for questions about managing profits. The main issue is “viability,” not “profitability.” And yet, as an RFI becomes sustainable and stronger the question of how to use net earnings becomes a policy issue. It is a subject that is best dealt with through appropriate rules established at an early stage of development.

The first need of a new financial institution is to build capital so that it can increase its business potential and survive economic or business difficulties. The first use of net revenues, therefore, should be to build the institution through additions to reserves.

After considering needs for more capital, decisions on using profits must relate to the business purpose of the RFI. If the purpose is to provide efficient services at the lowest reasonable cost, then earnings normally will be allocated to expand or improve

services. Such uses might include improving the RFI’s facilities, purchasing equipment (computers, software, telecommunications, etc.), and adding staff or training. These needs would be identified and addressed in the RFI’s annual business plan.

If some portion of profit remains after these needs have been met, then consideration can be given to distributing dividends to the members. The rules would anticipate this issue and provide a policy guideline.

RFIs in some countries have followed the policy of not distributing net earnings to shareholders. The concept is that if profits are reinvested in the institution, the members will benefit through a stronger institution with better, more competitive service. This is consistent with their business purpose.

In other situations, RFIs issue “patronage dividends.” Profits are apportioned to members, not on the basis of the number of shares they own, but rather on the basis of how much they used the institution. The larger their deposits and loans, the larger their patronage and related dividends. In this way, dividends reduce costs of credit to the members and increase returns on their deposits.

Still other RFIs distribute dividends on the basis of the number of shares owned by individual members. The larger an individual’s investment in the RFI, the larger the dividend.

If the policy on profit distribution is not established early, it can become a divisive issue when profits become available to the members.

Writing Rules on Profit Distribution

The policy should focus first on capital needs to strengthen the RFI. Meeting standards for capital and reserves should be an RFI’s first priority. If capital is scarce, then selling shares may be a consideration in these decisions. Second, the policy should direct that net earnings be used to fulfill the business purpose of the RFI.

After these priorities have been addressed, the policy should direct how remaining profits will be distributed to member/shareholders. Should profits be allocated on the basis of how much a member has used the RFI (patronage)? Or should profits be distributed to members based on their investment in the RFI (shares)? Rules should provide the policy framework for these decisions.

Examples of Rules on Profit Distribution

These rules need to be designed after carefully considering the business environment and the reason for RFIs. The following examples are provided only as illustrations:

- **Example.** As determined by the RFI board of directors, net earnings will be allocated first as contributions to capital and thus improve the institution’s financial strength; second, as reinvestment in the institution’s physical and human resources to expand and improve services to the member/users; and third, as patronage dividends to the shareholders on a formula approved by the members at an annual meeting.
- **Example.** The RFI board of directors shall determine how net earnings will be used. The first priority will be to build the capital strength of the institution and thus its long-term viability. The second priority will be to invest earnings in the physical and human resources of the institution to improve and expand services and reduce their cost to members. In view of the long-range benefits to members from a stronger,

more efficient financial institution, all earnings will be retained for this purpose.

Adjusting Profit Distribution Policies

Periodically the rules on distributing profits to the members should be reviewed. Any changes should be recommended to the member/shareholders for their approval. Temporary changes may be needed in times of peril. If the country is experiencing a major economic recession, for example, it may be necessary to require that all earnings be retained to build reserves to preserve the very existence of the RFIs. Under normal conditions, rules on allocating profits will be adjusted infrequently.

Board of Directors

In a user-owned organization, the members elect the board of directors to serve as the governing body. Board members should be chosen with care to ensure they are qualified to fulfill their responsibility.

How Are Board Members Elected?

Directors usually are elected by the members at an annual general meeting for a specified term of office. The bylaws or other organizational documents will specify the procedures and

whether proxy voting is permitted. If a vacancy occurs on the board before the normal term of office ends, bylaws will specify the process for filling the unexpired term. The board may select an individual to fill out the term, or a special general meeting may be necessary. The board will elect from among its members a chairperson and possibly a vice-chairperson to lead the board in carrying out its duties.

What Qualifications Should Directors Have?

A board member should be an active and knowledgeable member of the RFI, be honest and trustworthy, have the time to devote to the duties involved, be recognized as a leader in the community, and be a person who will represent the best interests of the institution.

How Long Should a Board Member Serve?

The term of office for a director is normally specified in the bylaws. A common term of office is three years with staggered terms, so that not all directors are up for election at the same time. Term limits should be established. For example, no director can serve more than two consecutive three-year terms. This allows other members of the RFI to have the opportunity for leadership and to inject fresh ideas and enthusiasm.

Should Board Members Be Compensated?

This will vary among organizations, depending on the financial condition and size of the institution. A newly organized RFI may not be able to afford to pay director compensation. If directors are compensated, it should be a nominal amount to cover lost revenue that a director realizes from the time spent on official duties. Even if no compensation is paid, directors are usually reimbursed for out-of-pocket expenses they incur in attending board meetings or working on special assignments.

What Are the Board's Governance Responsibilities?

The board of directors carries out its governance responsibilities by setting policies and employing a management team to carry them out. Policies of the board guide its own actions, direct the business activities of management and staff, and guide shareholder affairs. Policies should be in writing, maintained in a policy manual, and periodically reviewed to ensure that they are current and appropriate.

The primary responsibility of the board of directors is to ensure that the business is run in a way that protects shareholders' interests and promotes the success of the

organization. Such responsibilities include the following:

- A fiduciary responsibility to protect the financial integrity and soundness of the financial institution.
- Determining a strategic direction for the organization.
- Delegating day-to-day operational authority to management, but supervising activities to ensure that its policies are carried out.
- Hiring, firing, evaluating, and compensating the chief executive officer and making sure the RFI's management team is well qualified to run the business.

Fulfilling Fiduciary Responsibilities

The board of directors is charged with protecting shareholder interests in the institution. It fulfills this fiduciary responsibility by managing risk to protect and preserve the RFI and ensuring that the RFI is in compliance with all applicable laws and regulations. Risk management requires the board to watch a number of things, but the balance sheet is a primary area where risk is assessed. The board must be certain the RFI is (1) maintaining sufficient liquidity to meet withdrawal requirements; (2) maintaining the proper relationship between loans

and deposits; (3) building an adequate capital base, and (4) ensuring that enough income is generated to meet current obligations, pay interest on deposits, and maintain reserves at required levels.

Credit risk management is also important. Policies of the board need to establish the institution's philosophy on credit risk, prescribe levels of authority in the organization for approving loans, state the RFI's loan collection policies, and determine the types of loans the RFI will make (e.g. loan purposes, repayment terms, collateral, etc.).

Boards commonly appoint committees to oversee critical aspects of the operation. An internal audit committee, for example, would periodically review financial statements to ensure that policies are followed and the RFI's performance meets projections. Likewise, a credit committee would oversee loan-making activities. These committees serve as the eyes and ears of the full board of directors and report their findings to the board.

Setting Strategic Directions for the RFI

Careful planning is essential for the long-term success of a financial institution. An RFI should have a

written strategic plan setting forth both its service and risk objectives. The plan should include both operational and financial goals. Normally, management is given the responsibility to formulate the strategic plan that the board then reviews and approves, consistent with the mission of the RFI. A committee of board members may be appointed to oversee implementation of the strategic plan.

Supervising RFI Operations

A board of directors exercises its oversight responsibilities by establishing a reporting system through which management regularly informs the board on the RFI's performance and implementation of the strategic plan. Financial performance is an area that a board in a financial institution watches closely. This requires a solid knowledge of financial principles because the board must probe behind the numbers to identify any negative trends or developments that could adversely affect performance.

Developing the Management Team

One of the board's most important functions is hiring, directing, and evaluating the chief executive officer. The board should have a formal process for periodically evaluating performance of the chief executive officer and management staff. For evaluation, the

board should establish performance objectives in writing and ensure that management understands what is expected. If performance expectations are not met, the board must address the situation promptly.

Examples of Rules on Governance

Rules should ensure the RFI boards of directors fulfill their governance responsibilities. Such rules may require:

- Maintaining a written policy manual.
- Following all written policies.
- Adopting a comprehensive strategic plan.
- Management reporting on the RFI's performance at each monthly meeting of the board.
- An evaluation system to measure management's performance against written performance standards.
- Board committees actively monitor financial, credit, and other key areas of RFI operations.

Adjusting Board Policies as Conditions Change

Although the level of governance exercised by the board will vary by the size and complexity of the organization and its programs, rules should require every institution to have in effect the basic elements of a governance pro-

gram. This should include, as a minimum, a policy manual containing all of the RFI's policies, the strategic plan, requirements for management to report on bank operations and the program for evaluating management's performance. If an RFI is just beginning operations and is involved only in deposit taking, the level of required board oversight will be less than if the RFI also is making loans.

As the organization grows in size and its operations become more complex, the full board of directors will be less able to closely monitor all aspects of the RFI's business. In such cases, more reliance will need to be placed on committees of board members that will work closely with management to oversee specific operations. Rules on RFI governance should allow for flexibility as the RFI grows and matures.

Conflict of Interest

In its broadest sense, the phrase "conflict of interest" refers to any situation in which a person has two or more goals that cannot be reconciled. A conflict of interest exists when a person has a financial interest in a transaction, relationship, or activity that can affect (or has the appearance of affecting) the person's ability to

perform official duties and responsibilities in an impartial manner and in the best interest of the institution.

RFI boards must adopt policies and procedures for directors and employees to avoid conflicts of interest. Such policies prescribe standards of conduct (both requirements and prohibitions) that promote public confidence, preserve integrity and independence, and prevent improper use of property, position, or information.

The Importance of Standards of Conduct

The objective is to maintain public trust and confidence in the RFI. This requires directors and employees of a rural financial institution to abide by high standards of honesty, integrity, and impartiality. Every RFI must ensure that its directors and employees act in compliance with high standards of conduct so that conflicts of interest won't occur or appear to occur. They must not engage in activities that might impair their judgment or objectivity, or bring discredit upon themselves or the RFI. Both directors and employees should be held to the same standards of conduct.

Examples of activities that should be prohibited include:

- Deliberating on any matter affecting their own financial interests or those of relatives as defined by the RFI's policies and procedures on standards of conduct.
- Using or divulging information not available to the public that is acquired by working for the RFI or serving on the RFI's board.
- Using their position to obtain special advantage or favoritism for themselves, their relatives, or any person doing business with the institution.
- Using their position or information acquired in connection with the position for personal benefit or to solicit or obtain any gift, fee, or other compensation.
- Accepting any gift, fee, or other compensation that is offered to influence official action or obtain information.
- Serving as an officer or director of an entity doing business with the RFI.
- Violating the RFI's policies and procedures governing standards of conduct.

Setting Rules on Standards of Conduct

A rule-making body for RFI's should ensure that each RFI has effective policies and procedures to avoid conflicts of interest. The oversight authority may simply set requirements for such policies or provide model language for the RFI boards of directors to use in adopting their standards. In some cases, however, the regulatory body may find it expedient and necessary to issue rules on director and employee standards of conduct for all RFIs.

Examples of Rules on Responsibility and Conduct

- Directors and employees of the RFI shall maintain high standards of industry, honesty, integrity, impartiality, and conduct in order to ensure the proper performance of the RFI's business and continued public confidence in the institution. Avoiding misconduct and conflicts of interest is indispensable in maintaining these standards.
- To achieve high standards of conduct, directors and employees must observe, to the best of their abilities, the letter and intent of all applicable laws and regulations and policy statements, instructions, and procedures of the

institution and should exercise diligence and good judgment in carrying out their duties, obligations, and responsibilities.

Directors and employees of an RFI shall not:

1. Participate, directly or indirectly, in deliberations on, or the determination of, any matter affecting, directly or indirectly, the financial interest of the director or employee, any relative, any person residing in their household, any business partner, or any entity controlled by the director or employee, except those matters of general applicability that affect all members in the same way, (e.g., setting interest rates).
2. Divulge or make use of, except in the performance of official duties, any fact, information, or document not generally available to the public that is acquired by virtue of employment or association with the RFI.
3. Use the position of the director or employee to obtain special advantage or favoritism for themselves, any relative, any person residing in their household, any business

partner, any entity controlled by the director or employee or any person transacting business with the institution, including borrowers and loan applicants.

4. Serve as an officer or director of an entity that transacts business with the RFI.
5. Accept, directly or indirectly, any gift, fee, or other present that is offered to influence official action or to obtain information to which the director or employee has access.
6. Violate policies and procedures of the RFI governing standards of conduct.

Updating Rules on Conflict of Interest

The RFI's standards of conduct (policies and procedures) should be reviewed at least annually and updated as warranted. As the RFI grows and becomes more complex, the challenge of ensuring continued public trust and confidence in the institution also grows.

Capital Adequacy

Capital is the shareholders' equity or ownership in the assets of the institution. Adequate capital is needed to ensure the long-term

viability of the organization. Functions of capital in cooperative or user-owned financial institutions are largely the same as for commercial institutions. Specifically, capital:

- Provides a cushion to absorb fluctuations in net income that allows the institution to continue operating in times of loss or negligible earnings.
- Assures investors, stockholders, and the public that the institution is stable.
- Supports asset growth.
- Contributes to RFI earnings.

When Does an RFI Have Adequate Capital?

Determining the adequacy of an institution's capital position requires an evaluation of the critical variables that impact the institution's financial condition. Due to the varying degrees and types of risk in each institution, a comprehensive capital adequacy determination must be made on a case-by-case basis.

Factors in assessing capital adequacy include:

- Capitalization level
- Composition of capital
- Stability of capital
- Portfolio risk
- Management experience

How Do These Factors Affect the Adequacy of Capital?

Capitalization Level. The most common measurement of capitalization is to consider total capital as a percent of total assets. Since establishment and adjustment of an allowance for loan losses affects the level of capital, the adequacy of such reserves for loan losses should be considered first.

Evaluating the level of capital should include several considerations: Has an evaluation of the RFI's allowance for losses disclosed any shortfalls or excesses based on accepted accounting principles? Has the RFI achieved its optimum goal for capital? Is the institution's capital goal reasonable, well supported, and tailored to the circumstances and needs of the RFI? Is the current quality of capital (e.g., composition and stability) consistent with the quality that was intended for reaching the optimum capital level? And is the optimum capital goal periodically reviewed and updated? How do the institution's capital ratios compare to ratios of similar institutions?

Composition of Capital. Not all capital is the same. Different forms of capital have different characteristics and benefits for the institution. What is the makeup of the institution's capital (i.e.,

surplus versus stock)? Surplus (retained earnings) is preferred capital for several reasons. It is more readily available to absorb losses with fewer adverse consequences and it protects capital stock from impairment in the event of losses.

Stability of Capital. Several questions should be considered when determining stability of the RFI's capital position. What are current and projected trends in total capital, surplus, etc.? And what are the underlying factors causing such trends? To what extent do operational risks threaten the RFI's capital, either today or in the future?

Portfolio Risk. Portfolio risk should be considered several ways in assessing capital. What is the risk exposure as evidenced by the level, composition and trend of non-performing loans? What is the relationship between the amount of total capital to the amount of bad loans? How much concentration of credit exists in the institution's portfolio? The RFI should consider concentrations in loans to one borrower or a group of affiliated borrowers, or by industry, commodity, geographic area, etc., and the extent of concentration relative to the RFI's capitalization level.

Management Experience. The quality of management is a subjective, yet essential, evaluation in determining capital adequacy. Weak management and oversight will ultimately lead to deterioration in the RFI's capital position. The RFI, therefore, should consider management's experience and performance in areas that relate directly to the capital function. Consider the following questions: Has a formal, written capital adequacy plan been established and approved by the board of directors? Considering all the information, is the institution's optimum capital goal reasonable and adequately supported? Does the capital plan address quality aspects of capital in addition to quantity?

Examples of Rules on Capitalization

The following are examples of types of rules that might set standards for adequate capitalization of RFIs:

- Total capital as a percent of total assets to be maintained above a minimum level.
- Higher risk institutions required to maintain higher capital ratios.
- Surplus (retained earnings) as a percent of total assets to be maintained above a minimum level.

Safekeeping of Deposits

Safekeeping deposits of shareholders in rural financial institutions often presents special challenges because of their remote locations and limited facilities. Safety and security standards need to be addressed. While proper physical security measures are essential, equally important is the need for accurate accounting records. Bankers bonds should be in force whenever available.

Other measures in safekeeping deposits include (1) procedures for handling (controlling) cash on the premises, (2) how much cash is maintained on site to meet daily withdrawal and lending needs, and (3) how excess cash is invested.

Physical Security Requirements and Safekeeping Measures

The building in which the RFI is housed should have bars on windows and doors, a time lock safe, an alarm system, a passive intrusion detection system, and a fire extinguisher.

Cash and such negotiable items as checks and vouchers need to be kept in the RFI's safe under dual control at all times. This means two people are needed to open the safe and access its contents. The RFI should have a policy specifying

ing the maximum amount of cash (float) to be kept on the premises at the close of each business day. Any amounts over that should be deposited in a commercial bank or other financial institution in one or more types of interest-bearing, insured accounts.

Part of the safekeeping responsibility is maximizing the return on shareholder deposits consistent with maintaining the needed liquidity levels to meet withdrawal and loan requirements. The board of directors should establish a policy on investments that addresses maturities and types of instruments in which funds can be invested. Under normal circumstances, funds invested in longer-term, fixed-rate, deposits will earn a higher return than in short-term or demand deposits in a commercial institution.

Monitoring Safekeeping Activities

An internal audit committee of the RFI should routinely confirm that proper physical security measures are in place, that dual control to accessing cash and other negotiable instruments is maintained at all times, and that the cash on hand at the end of each business day does not violate the board's policy. A member of the board of directors should chair the internal audit committee. The rest of the

committee is either appointed by the board or elected by shareholders. Other board members normally serve on the committee and shareholders also may serve. Members of the internal audit committee should be trained in basic accounting functions of the RFI and in other areas that are important in carrying out their responsibilities.

Examples of Rules on Safekeeping of Deposits

Rules should direct the local institutions to take adequate physical and procedural measures to keep and administer deposits safely. The following are examples of the areas such rules should address:

- Physical premises of the RFI shall be maintained in a secure manner.
- Cash and other negotiable instruments shall be maintained under dual custody in a time locked safe.
- Cash on hand at the RFI shall be maintained in the amounts specified by board policy.
- Investments in commercial institutions shall be made in accordance with board policy.
- A bankers bond shall be in effect that protects against loss of deposits on the premises and in transit.

- The internal audit committee shall make periodic (e.g., weekly, monthly) inspections of the RFI's accounting records and security procedures.

Adjusting Rules on Deposit Safety

As deposits of the institution grow larger, the RFI will have more flexibility in the types of investments it can make. The investment policy should be modified accordingly to ensure that deposit funds are protected, not subject to risk, and earn the maximum reasonable interest. The bankers bond should be increased to cover deposit growth. Other forms of insurance to protect depositors should also be investigated.

Credit Policies and Procedures

Credit policies and procedures are the written guides, methods, and rules used by rural financial institutions to administer their lending programs on a sound basis.

The Need for Credit Policies and Procedures

RFIs need these rules to ensure lending practices that protect the safety and soundness of the organization, yet meet the credit needs of its member/customers. RFI employees, officers, and supervisors should use the manual

of credit policies to make sound lending decisions on a consistent and equitable basis. Sound lending is a corner stone in keeping RFIs sustainable, achieving financial independence, and attracting investment capital.

Who Should Adopt Credit Policies?

Each lending institution should adopt its own set of credit policies and procedures that recognize and relate to the needs of its borrowers, the experience of its employees, and that satisfy legal and regulatory requirements.

Because credit policies and procedures are the rules for lending, the highest level of organizational authority must adopt them. This may be the RFI's membership or credit committee, board of directors, board of governors, or other body of persons that is ultimately responsible for the compliance with applicable rules and laws and for the success of the organization. Staff members, directors, and others involved in lending use the credit policies and procedures both as their operating guidelines and as the authority delegated to them to make and collect loans.

Who Uses Credit Policies and Procedures?

All employees involved in the loan program of the RFI will use the

institution's credit policies and procedures. This includes persons that discuss loan programs, gather information, determine eligibility, review collateral, prepare analysis, approve loans, prepare documents, transfer and advance funds, and anyone involved in loan administration, collection and renewal activities. In small, start-up RFIs one or two persons may perform all of these duties. In some cases the board members, supervisors, or regulators may be involved in this process as well.

Do all Rural Financial Institutions Use the Same Credit Policies?

No. Each RFI that has separate governance should prepare, approve, and administer its own lending guidelines to meet the credit needs of its customers. These will be prepared within the framework of the RFI's mission and its capacity to lend money in a safe and sound manner. All branch offices of the same institution, however, will follow the same credit policies and procedures.

Are Credit Policies the Rules for Lending and Portfolio Management?

Yes. These rules should be carefully written as the principal tool in day-to-day management of the lending process. They should

be flexible and focused on customer service. Credit policies may also serve as the basis for portfolio management as the RFI grows in scope of business and maturity. Portfolio management includes overall risk management, loan loss tolerance, portfolio diversification, and general financial management of the RFI.

Credit policies and procedures, however, are not the only rules needed for managing the financial institution. The RFI must also prepare, approve, and adopt other management policies, rules, procedures, and guidelines to ensure overall success of the organization.

When Should Credit Rules Be Amended and Revised?

Credit policies should be amended whenever results indicate that the rules inhibit the organizational, financial, or administrative ability to satisfy customers' credit needs. Credit policies should also be amended when it is determined that they expose the RFI to excessive risk or if they are found to be too conservative. Procedures should provide for a periodic review of the credit policies.

Amendments to credit policies should be carefully considered within the context of safe and sound practices, financial re-

sources, success parameters, local conditions, legal and regulatory requirements, competition, employee experience, and the RFI mission. The highest level of organizational authority must approve all amendments.

Examples of Credit Policies and Procedures

As stated above, credit policies and procedures must be designed to fit the circumstances of each RFI. The following are examples of credit policies to illustrate concepts and principles.

Example. Accountability for Credit Policies and Procedures:

The board of directors, board of governors, credit or membership committee, or other body of persons of the rural financial institution responsible for its success (owner representatives) will develop and implement written standards for prudent lending and will issue written policies, operating procedures, and controls that represent good lending practices of the RFI and that comply with necessary legal requirements.

Example. Eligibility to Borrow: Credit policies and procedures will establish the minimum criteria and standards that any person or enterprise must meet to

borrow from the RFI. These may include requirements on investment, membership, or deposits in the RFI; residency; economic and employment status; and other conditions.

Eligibility standards will be written and published for distribution to potential borrowers and loan applicants. Those persons responsible for administering credit policies and procedures will decide an applicant's eligibility. This determination will be made prior to any decision or approval related to a request to borrow from the RFI.

Loans will be considered only for applicants who:

- Complete the required loan application form.
- Demonstrate the industry and character to carry out functions necessary to use and repay the loan and assure a reasonable chance for success.
- Do not have any delinquent debt outstanding, including taxes.
- Agree to participate in training or other programs that may be suggested or offered by the RFI to improve business knowledge and skills.
- Are authorized to do business and have the capacity to incur debt.

Example. Loan Purpose and Type of Loan: Credit policies will specify the purposes for which loans will be considered for eligible borrowers. Loans may be authorized, for example, for purchasing seed, fuel, and fertilizer, or for purchasing equipment needed to process or market farm products. Or, loans may be authorized to buy additional inventory or to provide working capital to cover expenses until goods are sold. Conversely, loans might not be authorized to support dairy cattle if there are no processing facilities or if markets are questionable.

These policies will specify and authorize short- and/or longer-term loans. The policies generally will not authorize direct investment (ownership) in a borrower's enterprise. Most loans made by newer RFIs will be in relatively small amounts (a few hundred dollars) and of very short duration (30-90 days). Loans for equipment or livestock will be made only if an applicant's cash flow is adequate to repay the loan in one year or less. Borrowers who establish a good repayment history may become eligible for loans of larger size and longer duration. Most loans for working capital will be short term and made on a collateralized basis to the extent possible.

Example. Lending Limits and Terms of Repayment: The maximum ***short-term***, individual loan for farm production or working capital purposes will not exceed the lesser of 5 percent of the defined, tangible capital of the RFI, or the local equivalent of \$1,000. The maximum ***long-term***, individual loan for facilities, machinery, and equipment will be the lesser of 5 percent of the defined, tangible capital of the RFI, or the local equivalent of \$2000.

Credit policies will establish repayment terms based on the applicant's circumstances and ability to repay. Loans funded by the RFI will carry repayment dates that do not exceed twelve (12) months or the time a borrower is able to repay in less than twelve (12) months. The actual repayment schedule will be determined after reviewing the borrower's business plan submitted with the loan application.

The RFI will adopt a repayment philosophy that each loan it makes will require full repayment and that loans are not a subsidized lending program that forgives the obligation due to adverse market conditions, prices, or other economic factors.

Example. Collateral Requirements: All loans normally will be made on a secured basis. The loan amount to any one borrower will not exceed 70 percent of the market value of the collateral. This may include crops and livestock held for sale within the term of the loan. Personal belongings, jewelry, and other assets that have value and that may be sold can also be taken as collateral. Some collateral may require safekeeping.

Other collateral may include: (1) farm equipment and vehicles in good working condition that can be appraised and will be of marketable value during the repayment period; (2) breeding livestock, dairy cattle, horses, and other production animals that will be in salable condition during the repayment period; and (3) other assets offered by the loan applicant or deemed necessary by the RFI to properly secure the loan. This may include third-party collateral or endorsements (guarantees).

Example. Interest Rates on Loans: Loans will bear interest at rates as determined by the board of directors and (under delegated authority) by those persons responsible for administering and approving the loan program. Rates will vary within a narrow

range, and the interest rate plan will be subject to continuous review and revision.

Rates charged on loans will be determined after considering:

- The RFI mission in regard to serving the needs of its members.
- Earnings objectives, capital requirements, and the RFI business plan.
- The nature of loan capital (e.g., public funding, member investments, donor contributions, savings and other deposits, or borrowed funds).
- Rates of competing institutions, usury laws, mandated or public policy limits, and other community, local, or regional requirements.

The Process of Approving, Administering and Collecting Loans

Rules and standards to be followed in approving and servicing loans will be an integral part of credit policies and procedures and will apply equitably to each loan applicant. The following is an illustration of a six-phase procedure for approving, administering, and collecting loans.

Phase 1. Initial Interview and Eligibility Determination:

- The RFI will develop loan application forms for use in

initiating discussions with the potential borrower.

- The loan expert will interview the applicant to determine eligibility to borrow. During this discussion the loan expert will learn the purpose, amount, and loan terms that the applicant is considering. The loan expert may assist the applicant in completing the application forms and preliminarily determine if the request meets requirements of the RFI's loan program.

Phase 2. Information Requirements and Loan File Management:

- When an applicant appears eligible for a loan and has completed all loan forms, a loan file will be opened and placed in the RFI files.
- The loan file will contain all documents required for evaluation, processing, recommendation, recording collateral, funds transfer, loan administration, and repayment. This will include the applicant's business plan along with verification of assets, liabilities, balance sheets, proposed earnings, and other documents.

- The loan file will be maintained after loan approval with the addition of periodic progress reports from the borrower. The loan expert will review the file, at least quarterly, to verify evidence that the loan will be repaid as planned.

Phase 3. Loan Analysis and Collateral Evaluation:

- The RFI loan expert will review the applicant's business plan and other related information, and will personally inspect the proposed project or enterprise, as well as the proposed collateral. If necessary, the loan expert will initiate an appraisal of the collateral. The reliability of this information and the character of the applicant will be verified through references and other sources.
- If by this analysis and verification process the loan expert concludes that the loan proposal is adequately supported, serves a useful purpose, and the business plan supports repayment, he/she will prepare a recommendation for approval of the loan.
- The recommendation will include such information as

loan amount, maturity, interest rate, collateral, reporting requirements, and other terms and conditions. The recommendation will include a summary of the risk in the loan and the schedule for disbursement of funds, as well as the requirements for type and quantity of collateral needed to secure the loan. This recommendation may be submitted to a committee of loan experts or referred to the board of directors for approval.

Phase 4. Loan Approval and Documentation:

- The RFI board of directors, or its equivalent, may act on the recommendation of the loan expert, or it may delegate this responsibility to a committee or individuals. Loan policies may delegate lending authority by different levels (usually by the amount of the loan) to different board members or loan experts. All loans granted under such delegated authority will be reported promptly to the board of directors.
- The loan applicant will be advised of the decision on his credit request and any conditions that must be met to

obtain the loan. When these requirements are met, loan documents will be prepared. Loan documents will include the promissory note to repay, the loan agreement, and documents needed to pledge the collateral to the RFI.

Phase 5. Loan Advances, Repayments, and Funds Transfers:

- For small working capital loans, the loan may be advanced to the borrower in cash. In some cases it may be appropriate to advance the proceeds directly to the vendor. Loan payments will be made directly to the RFI in cash or other equivalent as agreed upon. When the farm or business product is sold on a monthly or other periodic basis, the RFI will collect payment for the portions of collateral involved in the sale. Interest payments will be due with the scheduled loan repayments or, as in the case of longer-term loans, at specified periods that do not include principal repayments. Under certain circumstances, barter may be the accepted payment method. When necessary and where the facilities permit, funds will be transferred by wire. The loan file will contain a detailed

ledger showing the loan advances and repayments of the borrower.

- The loan expert will monitor repayment of the loan. If payment or interest is not received as scheduled, no further loan advances will be made. The loan expert will notify the loan committee and the board of directors of the delinquency as soon as possible so that appropriate servicing actions may be taken.
- The loan expert will take the necessary action to fully recover the principal and interest on the loan. In special cases, this may require small additional loans to see the borrower through unexpected difficulties that represent modest overall risk of recovery. Periodically, an extension or loan rescheduling will be determined to be in the best interests of both the RFI and the borrower. Should these efforts fail, the loan expert will attempt to satisfy repayment through liquidation of the collateral.

Phase 6. Monitoring and Servicing the Loan:

- The RFI will monitor performance of each of its loans and

maintain in its files current and comprehensive information on each borrower. The RFI also will assist borrowers in their efforts to succeed.

- RFI staff members will take the following steps to adequately service loans: (1) make periodic visits to the business enterprise to determine that loan funds are being properly used and to monitor progress of the operation (discussions with the borrower will focus on achievements and any anticipated problems); (2) inspect loan collateral as often as necessary to ensure that it is being maintained and remains adequate to support the loan; (3) provide supervisory assistance to the borrower in the form of technical and financial advice that would help ensure that operating weaknesses are being addressed; and (4) carry out any other monitoring requirements as may be established by the board of directors.

Managing the Loan Portfolio

Managing a loan portfolio requires an RFI to consider how past operating results were achieved, how probable similar results will

be in the future, and whether the RFI is maximizing opportunities and providing financial services that meet the needs of the member/users. It requires the board of directors to remain continually aware of the changing business environment. As the RFI develops its customer services, the board of directors must consider how the growing and changing portfolio of loans is managed.

Effective loan portfolio management may include:

- Business planning
- Credit policies and procedures
- Risk identification
- An internal credit review (ICR) program or process
- Other internal control procedures, such as reporting to the board, delegated authorities, performance plans and assessments, and loan committees

The size and organizational structure of the RFI also must be considered. As the size, diversity, and decentralization of operations increase and authority is spread throughout the organization, more comprehensive and effective risk management systems will be needed.

Business Planning. Business planning is a key step in managing the loan portfolio and provides the framework under which the board

and management direct and control lending. Strategic planning defines goals and objectives of the loan portfolio and provides the board an opportunity to anticipate conditions in the RFI's operating environment and react accordingly. Goals and objectives for managing the loan portfolio can be established when the operating environment has been assessed.

Examples of Business Plans

- The RFI's business and capital plans should quantify the anticipated expansion and contraction of loan volume.
- Operating loans, installment financing, loan participations, and other assets should be assigned target levels in the loan portfolio.
- Within targeted asset categories, plans should segment each loan category by commodity sector, loan type, geographic region, loan maturities, and credit risk classification.
- Plans should analyze expected impact of such external factors as volatile commodity prices, economic conditions, the rural credit market, pricing practices and services of competitors, interest rates, existing

and proposed regulations, technology, climatic conditions, and analysis of commodity markets.

- Goals and objectives should be set for the desired level of credit risk in the portfolio. This level of risk should be determined by reviewing both internal and external factors, with particular emphasis on the RFI's capital adequacy, profitability, and overall risk-bearing capacity.

Strategies to achieve goals and objectives may include:

- Modifying loan underwriting standards to allow more or less risk or to require compensating strengths when credit weakness exists
- Establishing credit administration standards (e.g., loan amortization rules)
- Modifying terms for extending credit
- Setting interest rates based on loan characteristics
- Modifying capital and risk funds positions

Goals and objectives should specify the desired portfolio mix and level of diversification. RFIs with credit concentrated in one commodity, or to a few affiliated borrowers, or to a single geo-

graphic area should consider strategies that:

- Monitor and reduce credit concentrations.
- Identify and monitor both existing and potential concentrations.
- Purchase or sell loans.
- Utilize loan participations.
- Increase capital.

The board of directors should establish goals and objectives for the loan portfolio's profitability. Strategies to achieve profitability goals may include:

- Modifying loan pricing policies and procedures.
- Monitoring profitability on a loan-by-loan and portfolio sector basis.
- Adjusting the interest rate spread or method of collecting interest on loans.

Credit Policies and Procedures.

Credit policies and procedures are important tools in managing the loan portfolio, as well as directing and controlling lending operations. Depending on the philosophy of the RFI, credit policies may provide general guidance to management or very specific direction. At a minimum, however, credit policies should facilitate constructive, safe, and sound loans, consistent with the goals and objectives in the RFI's busi-

ness plan. Credit policies, therefore, should be reviewed and updated at least annually. Management must implement operating procedures to ensure that the lending staff will adequately and consistently implement the board's credit policies. Rules and standards for credit policies and procedures are outlined in another section of this guide.

Risk Identification. Accurately recognizing risk in the loan portfolio is critical for sound management of the loan portfolio. Perceived loan risk is the basis for the RFI's plans, direction, and controls. An inability to identify risk in the loan portfolio realistically can threaten the safety and soundness of an institution.

Primary risks in the loan portfolio are credit risk and interest rate risk. Credit risk is the potential for losses from borrowers' failure to repay their loans, while interest rate risk is the potential for losses from interest rate fluctuations in the market. Identifying credit risk is the focus of this discussion, and interest rate risk is discussed in the Asset/Liability Management section of this guide. Interest rate risk is mentioned here to highlight the need to consider it in evaluating loan portfolio management.

An RFI's risk identification process should identify aggregate risks in the loan portfolio in several categories:

- Nonperforming loans.
- Past due loans.
- Nonaccrual loans.
- Restructured loans.
- Other property owned.
- Concentrations of credit.
- Dependence upon a single or a few customers.
- Loans that do not comply with loan underwriting criteria.
- Lack of borrowers' current and complete financial data.
- Other credit administration deficiencies.
- Loans with common credit factor weaknesses.

Information from credit evaluations, together with such other loan data as outstanding debt and commitment, loan type, terms, enterprise/commodity financed, and geographic location, should be accurately recorded and summarized by the RFI. Summaries should report current aggregate risk categories or other information needed by the board and management to understand portfolio risk. These may include common credit factor weaknesses on a group of loans, a breakdown of loan sizes, or the enterprises/commodities financed on certain

classifications of loans. The ability to retrieve data and generate information is based on the RFI's size and technical capacity.

Internal Credit Review Process.

Initially, the RFI may rely heavily on credit policies and procedures and other standards to achieve its customer service goals. As the RFI grows, it will be necessary to use additional processes and methods to maintain safe operations. Internal credit review (ICR) is such a process. Properly implemented, the ICR process requires access to loan data plus technical and human resources. Its use, however, may not be practical for emerging RFIs.

The ICR process can be a key part of an RFI's control system. Each RFI should establish a policy that includes the review and assessment of the loan assets. This involves (1) the ongoing assignment of risk ratings on individual credits, and (2) supervisory review and management of credit administration and loan servicing within the entire portfolio. The purpose of the ICR is to ensure that risk will be properly identified, serviced, and reported to management and the board.

An effective ICR process is critical to the board's ability to monitor RFI assets and management's compliance with credit policies and procedures, and the adequacy of those policies is largely dependent on the effectiveness of the ICR process. The oversight body needs to issue rules that require an RFI to establish policies and procedures that will assure an adequate internal credit review process.

Future Developments in Loan Portfolio Management

When a new RFI first begins making loans, it doesn't need an extensive portfolio management process. As the institution grows and matures, however, its management information system and procedures for managing the loan portfolio will become important. The RFI's board of directors and oversight body must monitor the risk in the loan portfolio and ensure that the risk is properly managed.

Asset/Liability Management

Assets of a rural financial institution are its loans, investments, buildings, and other valuable claims. An RFI's liabilities are its deposits, borrowings, and other debts.

A financial institution's assets and liabilities usually mature at different times. For instance, the RFI could have assets and liabilities that include:

- Deposits "on demand" or time deposits (e.g., certificates of deposit).
- Other borrowings (by the institution) to be repaid as 60 semiannual interest payments with principal repayment in 30 years, or the interest and principal may be due in a single payment in one year.
- Loans may be for fixed terms (long and short) or they may have no fixed maturity and require only periodic interest or principal payments.
- Such assets as land will never mature.

Each asset and liability may have a different interest rate that may either be fixed or variable.

Asset/liability management (ALM) is the group of activities that seeks to define and control the effects of changing interest rates on the institution's profits and net worth. ALM includes policy setting, execution, data collection, analysis, reporting, and monitoring.

What Risks Does ALM Try to Control?

Asset/liability management seeks to measure and control the effects of maturities and interest rates on the RFI's income or net worth. RFI managers must coordinate policies on loan interest rates and maturities with policies on deposit (liability) interest rates and maturities. Failure to do so can expose the RFI to cash flow (liquidity) and profitability (interest rate risk) uncertainties. Interest rate policies also can expose the RFI to loan repayment uncertainties. Large, complex institutions are exposed to many other interest rate related risks. These are the risks that ALM seeks to control.

For instance, assume a bank has 10 units of net worth and only one liability. The liability is a 90 unit certificate of deposit on which the bank pays a fixed rate of interest, say 10 percent, with both the deposit and interest due in one year. At the end of the year the bank must pay the depositor 99 units — 90 units of deposit and 9 units of interest expense.

Let's also assume the bank has a single 100-unit loan. The bank expects to earn a fixed rate of interest, 12 percent, with both the principal and interest due in one year. At the end of the year the bank expects to receive 112 units — 100 units of principal and 12 units of interest income. After the bank collects the loan and pays the depositor, it realizes 13 units of net income (112 – 99). From this net interest income it must pay any noninterest expenses. Any surplus will increase the bank's net worth.

Liquidity Risk. What if the deposit maturity was "on demand"? If the depositor demanded the return of his deposit after the RFI advanced loan funds to a borrower, but before the loan was due, the RFI would have no funds to pay the depositor. If the RFI was unable to find another source of funds, it would be unable to meet its obligations when due and would become insolvent even though, on paper, it would show assets greater than liabilities. This is the risk in RFI liquidity.

Interest Rate Risk. Suppose that the deposit matured in one year, but the interest rate paid by the RFI was equal to an indexed interest rate (of 8 percent) plus 2 percent. Further, assume that on the day after the deposit, the

indexed rate increased from 8 percent to 10 percent and stayed there for the rest of the year, making the effective interest rate paid on the deposit 12 percent. In this example, the RFI would still receive 112 units from the loan repayment, but it would owe 100.8 units to its depositor, leaving only 11.2 units of net income. This is a decline of 13.8 percent in net interest income. If we assume expenses are fixed, then the reduced net interest income will also reduce dividends, net worth, or both. In this way, interest rates can pose substantial risk for the RFI.

Repayment Risk. What if interest rates on both the loan and deposit were variable? At first glance, it seems as though this would solve all the RFI's problems. If interest rates go up, the RFI's interest rate expense would go up, but so would the RFI's interest rate income. Or would it? If the added interest rate expense was more than the borrower could pay, the borrower might default.

How Do You Manage Assets and Liabilities?

ALM should be considered in every decision made by the RFI's board and managers. It is not a functional or technical activity such as accounting, lending, or data processing, although it can

require a staff with specialized knowledge and skills. ALM activities that should be a part of an RFI's standard operating procedure include:

Awareness. The board and management of an RFI need to know how changes in interest rates can affect liquidity and profitability. Most visible risks are those of borrower default, or credit risk, and such operating risks as fraud and theft. ALM functions to make directors, managers, and loan officers aware of interest rate risks and principles of asset/liability management.

Policies. The board should decide how much interest rate risk it wishes the RFI to bear. While it may be possible in theory to insulate the RFI from nearly all effects of interest rate changes, doing so would be expensive. Successful RFIs evaluate and accept prudent levels of credit, interest rate, and other risks. The directors, as representatives of the RFI's owners, decide how much risk is prudent.

An oversight body should issue a rule requiring the board of directors of each RFI to adopt a policy statement on asset/liability management. As an example, a board might adopt a policy that states:

It is the policy of the board that the affairs of the institution shall be managed to limit the effects of interest rate changes on net income and equity. Specifically, a __ percent change in interest rate, either up or down, shall not reduce net income by more than __ percent or reduce the value of equity by more than __ percent.

Execution. RFI managers must develop procedures to carry out the board's policies. They need to understand how their actions, or lack of action, can affect net income and equity should interest rates change. Implementing ALM requires data collection, analysis, and decision making.

For small RFIs, ALM activities and policies will be carried out on the basis of daily decisions regarding liquidity of deposits (or other loan funds) and the maturity and likely repayment of loans.

The need for data and analysis depends on the size and complexity of the institution's balance sheet. Managers of a small RFI may need only to inspect a list of assets and liabilities sorted by date of first opportunity to change the cash flow associated with the item. Managers of larger RFIs probably will need a computerized database and a skilled analyst to maintain

the database and prepare the reports. Balancing assets and liabilities requires coordination among the various parts of the institution such as lending, deposit taking, funding and treasury.

Risk limits are often used to control risk. Once the board defines "acceptable risk" then management's role is to discover which activities expose the institution to interest rate risk and to control them. Training, supervisory oversight, and monitoring are also important, but setting clear and specific operating limits is essential. For instance, management (or the board) may limit the maturity of certain investments to specified periods, or limit the minimum (or maximum) maturity of a funding source, or limit the unit volume of fixed-rate loans or deposits. Each RFI needs to define its own risk profile and set up control mechanisms.

Data Collection and Analysis. Both the RFI's balance sheet and interest rates change daily. If the RFI makes long-term, fixed-rate loans and interest rates fall, some borrowers will seek to refinance their loans at the lower rates, while others may want to switch to variable-rate loans. A drought may affect farmers' capacity to repay, leading them to ask the RFI to reschedule payment amounts or

maturities. A large borrower may ask for special terms. Funding sources may demand new terms. Change is constant.

The amount and sophistication of data collection and analysis should be appropriate to the risks undertaken. Small institutions with simple loans and stable funding need less than large institutions with complex loans, investments, liabilities, and capital market funding sources. In increasing order of sophistication, the main techniques used to analyze interest rate risk are gap analysis, duration analysis, and simulation. These techniques, of course, probably are not appropriate for use by small emerging RFIs. They are mentioned here only because they represent the accepted form and method used successfully by many financial institutions.

Reporting and Monitoring. The board and management need to know how all these changes are affecting the RFI's exposure to interest rates. Regular, comprehensive reports are essential. Information provided in such reports should enable the board to assess, independently, whether management is complying with the board's ALM policies and whether the policies are prudent.

Interest Rates on Deposits and Loans

Interest rates on deposit accounts will be set by the board of directors and administered (through delegation) by staff members responsible for the RFI deposit function. The interest rate plan should be continuously reviewed and revised as necessary.

RFIs will be organized principally as cooperatives, mutual savings banks, credit unions, and savings and loan institutions. These RFIs will have interest bearing accounts as the mainstay of loanable funds and must compete for these funds with other deposit options available to rural customers. The amount of interest paid to the customer is of secondary importance to safety and liquidity.

On What Accounts Should Interest Be Paid?

RFIs will usually pay interest only on those customer accounts that are committed to the RFI as "time deposits." Time deposits are accounts that are represented by a written agreement between the RFI and the customer. Customers using time deposits can be either individuals or enterprises.

What Should Be Covered in a Time Deposit Agreement?

Time deposit agreements might be considered the "fine print" when a member deposits funds in the RFI, but the terms and conditions are of vital importance to the institution. Such agreements on deposit accounts, therefore, should be written with care and consideration of the following:

- The acceptable form of deposits and customer access to the funds.
- The minimum amount of deposit required to be maintained.
- The minimum number of days required for that deposit to remain in the RFI.
- Conditions under which the deposit maturity will be extended automatically.
- The basis on which interest earnings will be calculated, such as statutory, simple, or compounded.
- The amount of interest that the RFI will pay for a specific maturity and minimum.
- When and in what form interest will be paid to the depositor.
- Under what conditions the depositor will forfeit interest or otherwise be penalized.
- Conditions and value of the deposit for use as loan collateral.

- Depositor rights in the event of failure or liquidation of the RFI.
- RFI rights as to use of the deposit (and interest) in difficult times and as collateral.
- Disclosure as to the existence, sources, amounts, limitations, and costs of any insurance or guarantees of the deposit and interest that are available to the depositor.

What Should Be Considered in Setting Deposit Interest Rates?

Setting interest rates on deposits in an RFI requires considerable information and skill. The objective is to remain competitive with other institutions, provide members with a market return on their funds, and maintain solid earnings for the institution. The following is a list of some of the things that should be considered:

- Type of RFI (cooperative, savings bank, credit union, or mutual?) and the business purpose.
- Regional, national, or statutory limits.
- Amounts that support safe and sound practices, sustainability, and earnings objectives.
- Analysis of current economic conditions that support the depositors and the potential

effects of these conditions on the liquidity of the deposit liabilities.

- Rates that provide for a desired cost of funds as they relate to the "spread" forecast on loan volume.
- Rates that will be competitive with other institutions.

How Should Interest Rates for Loans Be Set?

Loans made by the RFI will bear interest at rates as determined by the board of directors and administered (under delegated authority) by those persons responsible for managing the loan program. Rates will vary within a narrow range among borrowers, and the interest rate plan should be routinely reviewed and revised as necessary. Differential rate programs may also be authorized and should be used equitably within categories of borrowers. Floating and variable rate programs may also be used as hedges against inflation, currency values, and cost of funds.

Interest rates charged to members on loans should be determined in part by:

- The earnings, capital requirements, operating "spread," and business plan of the RFI.
- The nature of the loan capital, such as savings deposits,

public funding, donor capital, hard member capital, or funds borrowed by the RFI.

- Consideration of loan amount, type, purpose, maturity, quality, the collateral security, and the expected loan servicing and collection effort.
- Mandated lending limits, regulatory requirements, or public policy parameters.
- Competing rates for similar loans in this locale.
- Other community, local, or regional requirements and considerations.

Accounting Standards

Accounting standards are principles and guidelines designed to achieve uniformity and to improve both accounting practices and reporting of financial information to the public, shareholders, issuers, auditors, and other users of financial information. In the United States, these are known as generally accepted accounting principles (GAAP). As defined by the American Institute of Certified Public Accountants (AICPA) Professional Standards, GAAP is “a technical term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time. It includes not only broad guidelines of general application, but also detailed

practices and procedures.” GAAP provides a standard by which to measure financial presentations of organizations.

Who Sets Accounting Standards?

Most countries have national accounting standards boards that are responsible for establishing the nation’s accounting standards. Many national accounting standards boards are members of the International Accounting Standards Board (IASB). The objective of the IASB is to achieve uniformity in the accounting principles used by businesses and other organizations for financial reporting around the world.

Why Follow Accepted Accounting Principles?

The importance of such rules is to enable readers of financial statements to be able to evaluate and analyze an entity’s financial condition. These principles provide a uniform framework for preparing financial statements that ensure that items affecting the financial condition of organizations are presented in a consistent manner.

Are Accounting Standards for Developing Countries Different?

Financial reports are prepared for a variety of users and for a variety of purposes. Thus, if there are differences in the objectives of

financial reports between the less developed and the more developed countries, it is because of the type of users and the purpose for which they are prepared. It is not because there are different accounting standards for less developed and more developed countries.

Almost all studies on the objectives of financial reports have concluded that a key objective of financial reporting is to satisfy the needs of users. In its publication, *Corporate Reporting: Its Future Evolution*, the Canadian Institute of Chartered Accountants identifies as many as 15 categories of users (see list at the end of this section). The list may not be exhaustive. Viewed critically, the list will substantially hold good for all countries, be they less developed or more developed.

Different users will have different needs for accounting information, depending on the situations and decisions faced, their level of understanding, and the alternative sources of information available to them. Typically in the developed countries, shareholders are the

dominant group. In the less developed countries, government plays a much more important part.

Accounting standards and financial reporting are not ends in themselves. Rather, they provide the means whereby people’s needs for information to make decisions can be met.

Updating Accounting Standards to Keep Pace with Change.

The economic, legal, political, and social environment in a country affects financial reporting. Financial reporting in most less-developed countries is limited to whatever information is required by law. Unfortunately, most of these laws are not updated regularly to take into account changes in the business environment. It is the responsibility of the RFI board to ensure that the accounting standards used in financial reporting are continuously updated to keep pace with the changing face of business. The source for these changes is each country’s national accounting standards board and the International Accounting Standards Board.

User Class

1. Shareholders	9. Industry Groups
2. Creditors—Long term	10. Labor Unions
3. Creditors—Short term	11. Government Departments and Ministers (federal, provincial, and municipal)
4. Analysts and advisors serving 1, 2, and 3.	12. Public-political parties (e.g., public affairs groups, consumer groups, and environmental groups)
5. Employees	13. Regulatory Agencies
6. Nonexecutive directors	14. Other companies (RFIs) (domestic and foreign)
7. Customers	15. Standard setters and academic researchers
8. Suppliers	

Reporting Requirements

Members of the board of directors of a rural financial institution have many responsibilities. They must ensure that the RFI is safe and solvent, that operating policies are sound, that accounting and control practices are adequate, that management is competent, and

that the staff is operating in a professional manner for the good of the members. The main way directors have to monitor these numerous performance concerns is by reviewing reports on the RFI's business activities. Reports on the RFI also are important for the

institution's managers, shareholders, depositors, supervisory agencies, government authorities, potential investors and creditors.

Types of RFI Reports

Every audit and review discussed in the Audit and Review section of this guide produces a report to communicate findings of the auditors. Together, these reports communicate the condition of the RFI to all interested parties.

Internal audits and reviews are required by policies of the board of directors and sometimes by the RFI's supervisory agency. Reports from internal audits and reviews help the board members know whether the staff is performing its duties prudently and in compliance with the RFI's policies, procedures, laws, and guidelines.

External audits should be required at least annually. The resulting report is distributed to all parties interested in operations of the RFI. A financial statement audit normally is limited to audit activities needed to support an opinion on the institution's financial statements. An unqualified audit report indicates that the financial statements present fairly the RFI's financial position, results of operations, and cash flows in conformity with accepted accounting principles.

Supervisory audits and reviews usually are required by law and conducted by the RFI's supervisory agency. The purpose of this report is to communicate to the RFI board and management an assessment of internal control systems and procedures in each operating function of the RFI and the related level of risk.

A **report of condition**, or "call report," is essentially a balance sheet and income statement with supporting schedules that provide detailed information on such items as cash, loans, deposits, other assets, and other liabilities. Typically, call reports are required by the supervisory agency quarterly to monitor the RFI's activities.

What Is an Effective Report?

The purpose of a report on a financial institution is to convey an accurate summary of performance and financial activities in ways that can be quickly and easily understood. Reports should be concise, but detailed enough to satisfy the needs of the readers.

Promptness in reporting is essential. Many figures and findings lose value rapidly with the passage of time. Reports must be accurate. Figures and findings must be verified thoroughly so that there are no factual errors. A single error can cast doubt on the

entire report and cause the reader to lose confidence in the reporter. To the extent possible, reports should be written in layman's language. The report writer must consider the audience that will be reading the report and should communicate to their level of technical needs. Finally, reports should be consistent in style and format to allow readers to identify trends and compare information with similar institutions.

Rules on Required Reports

The types, number, and detail of reports needed will vary with the audience and as the RFI grows and becomes more complex. The RFI board will need to continuously evaluate the adequacy and quality of reports on the RFI's operations. The RFI oversight body will need to issue rules that ensure RFI boards receive adequate information on their institutions. Other rules will specify the number, frequency, and type of reports needed from the RFI in order for the regulatory body to carry out its monitoring responsibilities.

Auditing and Reviews

Audits and reviews, whether conducted internally or externally, assist the RFI board in meeting its fiduciary responsibilities. The purpose of an audit and review program is to determine and

report to the board of directors whether management and employees are performing their duties in a prudent manner and in compliance with applicable rules.

The audit and review program is an internal control that detects problems, weaknesses, or errors after they occur. This characteristic is important in differentiating the audit and review program from other internal controls. Internal control procedures are incorporated into the plans, policies, and procedures of each RFI operating function. They are preventive in nature and built into procedures for the staff to follow. In contrast, the audit and review programs audit transactions and decisions after the fact and are performed by personnel outside the function being audited.

Why Are They Necessary?

Audits and reviews are needed to test and evaluate high-risk areas of an RFI's business. The objective is to detect potentially serious problems and communicate these findings to the RFI board so remedial actions can be taken promptly.

While some RFIs treat the audit and review program as one function, it is in reality two—the audit function and the review function. **Audits** determine the

adequacy of internal accounting controls and other operating practices. **Reviews** assess the adequacy of loan assets, lending practices, and collateral evaluations.

Audits and reviews can be done three ways:

- External financial audits that are performed by public accountants.
- Supervisory audits and reviews that are conducted by the RFI oversight body.
- Internal audits and reviews that are conducted by staff members of the RFI.

Who Manages Internal and External Audits?

The RFI board of directors is responsible for managing the RFI's external/internal auditing program. Most boards form an audit committee of board members to oversee the RFI's accounting and financial reporting policies and procedures. The audit committee is the direct line of communication between the board and the RFI's external and internal auditors.

What Does the Audit Committee Do?

Responsibilities of the audit committee include:

- Considering management's recommendation on the appointment of an outside auditor.

- Reviewing the independent auditor's proposed approach and scope of audit.
- Communicating with, and evaluating the effectiveness of, the internal auditors.
- Reviewing financial statements and results of the independent audit.
- Considering the selection of accounting policies.
- Reviewing recommendations on improving internal controls.
- Overseeing or conducting special investigations or other activities on behalf of the board of directors.

How Do the Three Types of Audits Differ?

A **financial statement audit** is conducted by an independent public accountant in accordance with accepted accounting standards and normally is limited to audit activities needed to support an opinion on the financial statement. A financial statement audit may not include an evaluation of all internal controls. The board of directors or its audit committee should determine if the audit plan will provide adequate information on the institution's risk areas and other areas of concern, particularly if reliability of the RFI's internal audits and reviews are in question.

An **internal audit** and review program is a key part of an RFI's system of internal controls. Its purpose is to determine and report to the board if management and staff are performing their duties prudently and in compliance with applicable policies, procedures, and other rules. Simply stated, the purpose of an internal audit is the prevention and detection of loss.

The **supervisory audit** and review program is conducted by the supervisory agency to determine if the RFI's internal controls are adequate. While the supervisory audit focuses primarily on internal controls, it also evaluates the RFI's management. The supervisory agency reviews loans and loan related assets to see if management is adequately identifying risk in the loan portfolio and taking corrective action when necessary.

What Are Internal Controls?

Internal controls are the procedures established by the board and management to ensure that objectives will be achieved and deficiencies will be prevented or detected in a timely basis. A strong internal control system provides the framework for accomplishing management

objectives, safeguarding assets, accurate financial reporting, and compliance with laws and guidelines. Internal controls serve as checks and balances against undesired actions and help ensure that RFIs operate in a safe and sound manner. The lack of internal controls increases the risk of mismanagement, waste, fraud, and abuse.

Internal controls include everything in the RFI that safeguards its assets, checks the accuracy and reliability of accounting data, promotes operational efficiency, and encourages adherence to RFI policies. There are two types of internal controls—administrative and accounting. Administrative controls are management's procedures and records for making decisions on transactions of the institution. Accounting controls are the procedures and records concerned with safeguarding assets and keeping reliable financial records.

How Often Are Audits and Reviews Needed?

External audits normally are performed annually, but the audit committee, based on the RFI's level of risk, determines the

frequency of external audits. High-risk institutions may need independent audits more frequently. Internal audits and reviews are conducted as often as the audit committee considers necessary, based on risk identified in various operations of the institution. Supervisory audits and reviews are performed as often as deemed necessary by the supervisory agency; however national laws often set a minimum frequency for supervisory audits. Rules of the oversight body should specify the number, type, and frequency of audits and reviews required.

The audit committee should continually review the effectiveness, frequency, and quality of the internal and external audit and review programs to ensure that they meet needs of the RFI and adequately address all areas of risk.

Compliance with Other Laws

RFIs will be required to meet the relevant national, regional, and local legal requirements necessary to perform their financial services

activities. In addition, in some jurisdictions, separate business registration (licensing) may be required.

Different organizational laws may apply to different RFI structures. These may include credit cooperatives, credit unions, savings and loan associations, private banks, and other lending institutions. Depending on the RFI's business territory, registration and legal status may be required in multiple jurisdictions.

What Types of Laws?

Depending on the jurisdiction and complexity of the RFI, it may be subject to laws regarding equal employment, environmental compliance, taxation, safekeeping or liquidation of collateral and deposits, and purpose of the banking operation.

Some laws may require an RFI to agree to perform to certain standards. Others require actions in order to be licensed to do business. In some jurisdictions, laws may require RFIs to report on financial affairs of their customers or remit sums to authorities to satisfy tax obligations.

Monitoring Compliance

Most of the laws will be established public record at the appropriate national or local jurisdiction. Some regulations may be in the form of rules or standards embodied in banking regulations. Some laws and legal requirements could be tailored to newly organized RFIs.

The awareness of all-applicable laws, regulations, and operating requirements is the responsibility of the highest level of organiza-

tional authority. This responsibility may be delegated to the CEO or outsourced to legal experts.

Such other laws may not only require compliance, but also reporting, oversight, and sanctions for noncompliance. Rules by the RFI oversight body may be needed to ensure that the rural financial institutions have procedures to ensure ongoing knowledge of these other legal requirements and take adequate steps to comply.

It will be necessary to collect and analyze key balance sheet, income, and other data to monitor the RFI's activities and financial performance. Oversight authorities will need this information to assess the institution's condition, observe trends in growth and performance ratios, and detect any underlying financial problems. A well-designed surveillance program can contribute to improved efficiency, budget savings, and improved oversight readiness and response.

What Are the Objectives of Monitoring?

There are a number of objectives in monitoring RFI activities and condition:

- Identify problems or potential problems.
- Recognize problems early enough to avoid institutional disasters.
- Better understand what remedies are needed to resolve problems.
- Know if appropriate steps are being taken to mend the problems.
- Prioritize problems in order to focus resources where most needed.
- Enhance communication between RFIs and the oversight body.

What Are the Tools for Monitoring?

Successful off-site surveillance requires current and accurate information. Such information normally is available from three sources—RFI reports, data of the oversight body, and other external sources.

RFI Reports. RFIs will need to routinely supply various documents and reports to the oversight body. While necessary for effective oversight, report requirements must be sensitive to the realities of RFI resources and the ability of the supervisory organization to analyze and make effective use of the reported information. Examples of information that might be required from RFIs include:

Quarterly Financial Data. Reports should present information on the RFI's financial condition and performance, loan performance status, commitments and contingencies, reconciliation of capital, and information on other business activities.

Annual and Quarterly Stockholder Reports. These reports present the financial condition and performance of the institution on a specific date and compare the data with comparable reporting periods

in the past. They should accurately reflect the success of the RFI's operations in achieving its business purpose.

Business and Financial Plans.

These documents present the institution's operating plans, business philosophy and targets, as well as the organization's budget. They are useful in comparing actual RFI performance to earlier forecasts and objectives.

Internal Audit Reports. Every RFI should have an internal control function. Reports are prepared periodically on the adequacy and effectiveness of these controls. RFIs should provide internal audit reports to the oversight body for review and analysis.

Other Information. Other information and reports prepared by RFIs that may be useful and readily available include:

1. Monthly board and committee meeting minutes.
2. Monthly reports of operations (board report).
3. Credit reviews and financial evaluations.
4. Changes in policy and procedures.
5. Organizational and personnel changes.
6. Newsletters and information sent to shareholders.

Data of the Oversight Body. A wide range of information usually is available within the oversight body. Some of these may include:

- **Permanent Oversight Files.** Permanent files provide an important source of background information on a rural financial institution. Past evaluations of the institution by the oversight body, including planning documents, inspection reports, and correspondence, are available in the permanent files.
- **Enforcement Action Files.** Files will be maintained on enforcement actions taken against RFIs. These documents should be available for review and background.
- **Special Studies.** The oversight body may perform economic studies. These studies and reports provide useful information on such issues as real estate value trends, commodity prices, business conditions, etc.

External Sources. External sources can provide useful information to assist in the oversight of an institution. Significant external sources include:

- **Audit Reports and Management Letters.** These documents from the institution's independent accounting firm outline deficiencies or weaknesses found during the audit. Additionally, any significant weaknesses in the institution's internal controls should be noted. These documents should be reviewed so there can be prompt follow up on any deficiencies cited.
- **Publications and Periodicals.** Central bank bulletins, Ministry of Agriculture reports, banking publications, newspapers, university research studies, and other industry studies can provide important information on such factors as climatic conditions, commodity prices, production costs, the competitive lending environment, business conditions and real estate value trends. Knowing these external factors and their potential effect on RFIs is important in understanding the operating environment of the institutions.

What Analysis is Needed?

Information obtained by the oversight body should be reviewed and analyzed on a periodic and timely basis in accordance with each RFI's level of risk. Analysts should organize and present the information in a factual, logical format for use in making evaluations and judgments. The financial condition of the institution, inspection reports, overall economic conditions, and the effectiveness of institution management generally determine the scope and frequency of analysis needed.

Conclusions from the information received and analyzed will determine if more information is needed or if direct contacts with the institution are required. Even if contacts with an RFI are oral, they should be documented in the files.

Critical weaknesses or adverse trends identified through monitoring or off-site analysis should be addressed as soon as discovered. Any significant problems or deterioration should be recorded and additional follow-up action taken in a timely manner.

Enforcement

The goal of oversight and supervisory activities is to ensure that RFIs operate in a safe and sound manner, operate in compliance with laws and regulations, and take corrective actions when needed. Enforcement is the method used to motivate corrective actions. When audits identify unsafe, unsound, or illegal banking practices, supervisory agencies use a variety of steps to ensure that rural financial institutions take corrective actions.

Informal Actions

- Guidelines and prior approval requirements.
- Reason and moral suasion.
- Board resolution.
- Memorandum of understanding.

Formal Actions

- Cease and desist orders.
- Civil money penalties.
- Suspension or removal of the RFI board, a single board member and/or management.
- Suspension or termination of deposit insurance.
- Placement in conservatorship or receivership or revoking an RFI's charter or license.

Not all supervisory agencies will have the authority to initiate all of the above enforcement actions. It will depend on banking laws in each country and the authorities

delegated to the supervisory agency. Each oversight body or supervisory agency must determine its degree of authority to levy enforcement actions.

Why is Enforcement Needed?

Enforcement is necessary to protect the rural financial institution, its members, and other stakeholders. The purpose of an oversight body is to ensure that RFIs maintain safe and sound business practices.

Enforcement actions usually are initiated when an RFI is engaging in unsafe and/or unsound practices and the board and management are unable or unwilling to correct the problem. It is also necessary if the RFI is doing things that pose excessive risk, regardless of the RFI's financial condition, such as unwise lending. A partial list of deficiencies includes:

Management Problems

- Unsatisfactory management.
- Poor loan administration.
- Insufficient planning.
- Inadequate internal controls.

Financial Problems

- Inadequate capital.
- Inadequate loan loss reserves.
- Undue concentration of loans.
- Operating losses or inadequate earnings.

- Failure to recognize or charge off loans.
- Poor liquidity.
- Failure to file with supervisory agency or filing of inaccurate reports.

Which Enforcement Methods Should Be Used?

The method of enforcement should fit the level of risk a problem poses to an RFI. For example, if a problem poses a low to moderate risk to an RFI and the RFI has both capable management and a board who are willing to address the problem, reason and moral suasion may be all that's required. On the other hand, if a problem poses a serious and immediate risk to the safety and soundness of the RFI, a firmer method of enforcement that is enforceable by law may be required.

Enforcement actions most often should be communicated to the board of directors at a board meeting. The meeting may or may

not be in executive session. Face-to-face meetings between the RFI board and supervisory officials tend to punctuate the seriousness of the issues. It is easier to gain a commitment from the board to correct the problems in face-to-face meetings than by communicating by letter or telephone.

Are Enforcement Powers Adequate?

Oversight bodies need proven effective and practical enforcement tools to deal with day-to-day issues involving unsafe and unsound practices and to remove dishonest and incompetent officials from the RFIs they supervise. Supervisory agencies lacking enforceable authorities should work closely with government officials to acquire appropriate authorities so they will have the tools needed to ensure that RFIs comply with laws, regulations, and directives. This is especially true as rural financial institutions grow and become more complex.

Relationship with Other RFIs

RFIs that share common community, purpose, organizational, and financial interests often affiliate to help ensure their individual success. This can include RFIs that are similarly organized, such as savings and credit cooperatives, village banks, credit unions, or others. But affiliation could also mean working with funding sources, commercial banks, regulators, or political and community interest groups. Affiliated RFIs normally will have such common characteristics as service to rural borrowers, limited lending capital, minimal staffing and administration, and the goal of benefiting the local community.

What Is an RFI System?

RFIs that band together can form alliances and agreements that promote their activities as a system of RFIs. Such affiliations usually are based on needs for service, capital restraint, profitability, political criteria, sustainability, administrative efficiency, bargaining and lobbying, and regulatory and legal requirements.

A system of RFIs can achieve added creditability for its local institutions, a broader service

base, and the ability to share human, financial, and technical resources. Such affiliations should accomplish what the individual units would have difficulty achieving independently. Benefits could include access to wholesale funding sources, banks of participation, self-regulation, lobbying, peer review and monitoring, and administrative outsourcing.

An RFI system could be formed on the basis of common structure, service base, financial well being, and goals and objectives. The system would have the ability to form affiliations for the group that benefit all of the participants. An RFI system should focus on economic gains and manifest mutual benefit to all member institutions.

How Would an RFI System Be Formed and Managed?

Such systems usually are organized with formal written agreements that outline the purpose, potential benefits, responsibilities, and life of the agreements. In addition, the agreements will acknowledge any self-regulatory requirements. RFI participants will employ and direct management for the system organization.

Examples of RFI affiliations, agreements, and system activities:

Type/Need	Purpose	Formalized by
Develop self-funding	Sustainability vs. dependency	Formal agreement and commitment or ownership
Expanded lending authorities and marketing	Broader service and competition, ability to buy and sell loans	Participation agreements or formation of second-tier institution
Bargaining/lobbying	Consolidate common interests	Formal agreements and commitments
Credit administration	Best practices, better results	Resource sharing by way of affiliation and cooperation
Resource and information sharing	Improved results, system perception, peer interaction, strength/compliance	Formal agreements and commitments
Marketing and public relations	Improve image and increase market share	Formal agreements and budget commitments
Procurement	Purchase equipment, supplies, and services at a lower cost	Formal agreements
Regulation and supervision	Improve results, attract resources, meet legal or system requirements	Common business and policy format, formalized and agreed upon approach, or compliance with existing banking regulations

Need for a Supportive Policy and Legal Environment

Rural financial institutions are more successful and their regulatory bodies most effective when there is a national attitude that wants them to succeed. A supportive environment includes both a positive, stated policy of the national government and a clear, efficient framework of commercial law.

RFIs will be established more quickly when governments make financial services for rural people a priority and recognize user-owned rural institutions as the best means of delivery. An announced policy, whether at the national, provincial or local level, is a government's commitment to fulfill this objective.

A government policy has numerous impacts. First, it informs the public that the government is supporting the establishment of RFIs to provide financial services to rural people. This becomes a directive to all ministries, departments, bureaus, etc., to support the effort. A government can go a step farther, as it has in the United States and a number of other countries, by providing seed capital (loans or grants) to capitalize the new institutions in a

partnership with RFI shareholders. Another form of government support can be through its corporate tax policies. To help nurture the fledgling RFIs, it could exempt user-owned RFIs from all taxes. Such a measure would result in little loss of tax revenue, but yield great benefit to the small institutions and their members.

RFIs also need laws that will backstop their business. A commercial code gives financial institutions the legal framework to operate. Specifically, there needs to be a strong code that clarifies the status of loan collateral. A major reason Hungary's rural Savings Cooperatives were in difficulty in the 1990s was because they could not claim collateral on defaulted loans. Rural Credit Cooperatives of China are hampered in making loans in the community because land cannot be pledged as collateral. In some countries there is an adequate commercial code, but the court process is so time-consuming and expensive it is impractical for administering small loans. A strong commercial code and an efficient court process are essential for small financial institutions to sustain themselves.

All such measures contribute to an environment that promotes and facilitates the successful startup of rural financial institutions. The number of supportive measures and the extent to which they are enacted are in direct relation to the

government's recognition of the need for rural people to have financial services—especially credit—and the government's commitment to establishing rural financial institutions as the solution.

Sustainability Checklist

Each of the RFI policy and procedural issues discussed in this guide, in themselves, can lead to institutional weakness and failure if not properly addressed. This is why a code of supportive rules and standards is so important. Responding to this checklist of critical issues can provide a quick assessment of the completeness and adequacy of RFI operating boundaries. Forthright answers to the following questions can give a general indication of how well the operating framework may assure sustainable institutions.

- [] **Business Purpose.** Has a written statement of the business purpose of rural financial institutions been adopted? Does a stated RFI mission tell why the institutions exist and what benefits they are intended to bring to the users and the rural community?
- [] **Scope of Business.** Do rules of the oversight body establish the kinds of services and business activities RFIs can and cannot undertake? Do they make clear where and with whom RFIs are authorized to do business?
- [] **Ownership.** Is the ownership structure of the RFIs clearly defined in the organizational documents?
- [] **Customers and Members.** Do rules require RFIs to adopt proper policies and procedures on relations with their user/owners? Are RFI responsibilities to the members made clear? Are provisions in place to assure that a member “in good standing” is defined?
- [] **Profit Distribution.** Have RFIs determined how net earnings will be used, particularly with regard to profits that might be allocated to members? Are boards of directors required to set policies on this practice?
- [] **Board of Directors.** Do rules prescribe how members will elect their RFI boards of directors? Have the boards’ governance and fiduciary responsibilities been made clear?
- [] **Conflict of Interest.** Has a code of conduct been written for RFI directors and employees? Have lists of prohibited acts been prepared and disseminated to RFIs?
- [] **Capital Adequacy.** Have rules been set on levels of capital needed to assure the safety and soundness of RFIs? Have minimal capital ratios been determined? Are boards of directors required to adopt policies on capital adequacy for their institutions?
- [] **Safekeeping of Deposits.** Are rules in place on security requirements for safekeeping bank assets? Do they call for procedures to assure deposit safety? Are boards required to monitor RFI safekeeping activities?
- [] **Credit Policies and Procedures.** Have rules been issued that require written procedures to guide the day-to-day RFI lending process? Do RFIs have to establish rules and standards for making and servicing loans?
- [] **Managing the Loan Portfolio.** Are business plans mandated in rules for RFIs? Are RFIs required to have an internal credit review process? Do rules call on RFI boards to monitor and manage risk?
- [] **Asset/Liability Management.** Do rules require RFIs to recognize and manage risks inherent in the institutions’ assets and liabilities? Do they mandate RFIs to control the effect of changing interest rates on the institution’s profits and net worth?
- [] **Interest Rates.** Do rules of the oversight body guide RFIs in setting interest rates on deposits and loans consistent with best banking practices?
- [] **Accounting Standards.** Have accounting standards for rural financial institutions been established? Are RFIs required to follow the standards? Does the designated accounting system provide adequate information on RFI performance for the needs of different users?

Definition of Terms

- [] **Reporting Requirements.** Do rules of the oversight body specify the number, frequency and type of reports needed to monitor RFI operations? Are the reports accurate, timely and subjected to professional analysis?
- [] **Auditing and Reviews.** Does the oversight body require RFI boards to manage external and internal audit programs? Must RFIs maintain audit committees? Are boards of directors required to ensure that internal controls are adequate?
- [] **Compliance with Other Laws.** Are RFIs required by oversight rules to comply with all other applicable laws (e.g., usury, taxation, and employment)?
- [] **Monitoring Compliance.** In addition to reports required from RFIs and operational assessments, are rules in place that provide for inspections by the oversight body?
- [] **Enforcement.** Is the oversight body equipped with effective and practical tools for enforcement to ensure RFIs comply with laws, rules and standards?

This section is provided to assist the reader with terminology that may or may not be used in different countries in the context of rural financial institutions. The definitions are based on the premise set forth early in the guide—that the RFI is a user-owned, membership organization.

Allowance for Loan Losses. A key part of managing the loan portfolio is to anticipate the amount of losses an RFI may experience in the future. To offset projected losses and protect the RFI, the board of directors may direct that a portion of net earnings each year be set aside as reserves to compensate for possible losses. These allocations become the RFI's allowance for loan losses.

Bankers Bond. This is an insurance contract for a financial institution that covers, within limits stated in the contract, losses incurred from default or dishonest activity of a third party.

Link Bank. Unless they are part of a fully integrated banking system, most RFIs must establish a banking relationship with a commercial bank. The commercial bank will enable the RFI to deposit excess cash for a productive return of interest. The commercial bank may facilitate transfers of funds as well as offer advice and counsel. A commercial bank entering into

such a banking relationship with an RFI is often called a link bank.

Loan Portfolio. The collection of loans a financial institution currently has outstanding to borrowers is considered the RFI's portfolio of loans.

Micro-Finance Institution (MFI). An MFI is an organization that makes small loans to entrepreneurs, farmers, artisans, and other business people as well as consumers. Its primary purpose is to provide credit to small borrowers but it normally does not take deposits or provide other financial services.

Mutuals. The term “mutual” as used in this guide refers to a saving association that issues no stock and is owned and controlled by savers and borrowers. Mutual associations also are found in the insurance and housing industries.

Negotiable Instruments. These are written contracts containing an unconditional promise to pay. They may be transferred

by endorsement or delivery to another party and must be payable to bearer or on order. Examples include bills of exchange, promissory notes, and bonds.

NGO. NGO is the acronym for “non-government organization.” Most NGOs are international organizations that rely on financial contributions from donors. For the most part, they are involved in economic and social development. To facilitate development projects they often provide small loans to finance their clients.

Oversight Body. The term “oversight body” has been used in this guide to refer to any organization that may have a role in the successful operation of one or more rural financial institutions. It could be an independent RFI regulator, a department in a ministry of the national government (e.g., agriculture or finance), an office in a central bank, a self-regulatory organization, trade association or some combination thereof.

Parastatal. Parastatal organizations are business enterprises owned and controlled by the state. These government businesses may include railroads,

airlines, hospitals, banks, etc. Parastatal businesses in agriculture could include sugar mills, fertilizer plants, cotton marketing firms, farm equipment companies. Examples of parastatal banks serving rural people and farmers include South Africa’s Land Bank, Poland’s Bank for Food Economy and China’s Agricultural Bank of China.

Proxy Voting. Voting by proxy is the act of assigning your right to vote to another party. If, for example, you are a member of a cooperative and unable to attend the shareholders’ annual meeting, you may choose (if allowed by the rules of the cooperative) to authorize a neighbor or friend to vote in your place on issues to be voted on by the membership.

Rules and Standards. These terms have been used to refer to requirements or limitations that may be imposed on RFI operations. The words “regulations” and “regulator” have been avoided because they may have negative connotations in some countries.

Rural Financial Institution (RFI). A rural financial institution is an organization providing financial services to people and businesses in rural areas having

little or no access to commercial banking services. An RFI may take deposits, makes loans, and provides other financial services such as funds transfers and insurance. RFIs may be organized as credit cooperatives, cooperative banks, savings associations, *caja rurales*, or others, but they have the common purpose of providing financial services to rural people.

Spread. The spread, or more specifically the interest rate spread, is the difference between the interest rate charged a borrower on a loan and the lender’s cost for the funds being loaned.

Village Banks. Small financial institutions in rural villages often are called village banks whatever their organizational structure. Financial Services Cooperatives in villages of South Africa frequently are referred to as village banks. MFIs in some countries also are called village banks. Because “village banks” means different types of institutions in different situations it was not used in this guide. The authors consider “rural financial institution” a more generic term for organizations providing financial services in rural communities.

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