Agriculture and Forestry—Agriculture Financial Services Corporation—Systems to Manage the Lending Program

SUMMARY

The *Agriculture Financial Services Act* gives Agriculture Financial Services Corporation a broad lending mandate. The Act allows AFSC to offer agriculture development loans and certain non-agriculture loans.

AFSC, with its lending program, serves approximately 12,000 customers through its 46 offices located across the province and supports primary agriculture producers, such as farmers, as well as commercial businesses and agribusinesses in Alberta. As at March 31, 2016, AFSC had approximately $2.16 billion in loans to Albertans and Alberta businesses.

What we examined

We examined AFSC's systems to manage, monitor and measure the performance of its lending program. In our audit, we set out to answer three questions:

- Has AFSC clearly defined the objectives of its lending program?
- Is there proper oversight of the lending program to ensure it is delivering the desired results?
- How is the lending program funded, and how much does it cost Albertans?

Overall conclusion

While the lending program has, for many years, provided a source of capital to agriculture producers and agribusinesses in Alberta, it lacks strategic direction. Without clearly defined strategic objectives, AFSC's lending activities could easily deviate from its development focus and replicate what other commercial lenders provide, rendering the lending program ineffective.

There are weaknesses in the oversight of the lending program. The department did not formally communicate to AFSC or document its performance expectations of the program. The former board of directors did not ensure that AFSC had adequate systems to monitor and measure the program's performance and manage the risks one would expect in a lending institution.

AFSC has adequate procedures and controls for its day-to-day credit administration activities, which include loan disbursement, loan processing and collection, collateral documentation and interest calculation.

What we found

Strategic objectives of the program

AFSC has not clearly defined the strategic objectives for its lending program and has not carried out an in-depth analysis to identify the sectors that are underserved by other lenders so that it can focus its lending activities to help those sectors.

Oversight of the program

The department's and the board's oversight roles and responsibilities in relation to the lending program are not clearly defined and documented.

The department did not formally communicate its expectations of the program's performance to AFSC, and AFSC's former board of directors did not exercise proper oversight in terms of monitoring the program's performance and managing the risks associated with the program.

In June 2016, the minister dismissed AFSC's board of directors and replaced it with an interim board. There will be an opportunity for the new board, once appointed, to work with the Department of Agriculture and Forestry to clearly define the oversight roles and responsibilities of both parties.

Program funding model

At present, AFSC receives an annual contribution from the department to fund the gap between budgeted revenues and budgeted expenses of the lending program. Under this funding model, there is no need or incentive for AFSC to accurately track and report the cost of its individual lending products. As a result, the government does not have sufficient information about what its contribution is used for.

What needs to be done

The Department of Agriculture and Forestry and Agriculture Financial Services Corporation should work together to:

- define the strategic objectives of the lending program
- define the oversight responsibilities of both parties in relation to the lending program
- develop a funding model that promotes accountability for the results of the program

Why this is important to Albertans

Thousands of Albertans rely on AFSC for capital to grow their businesses. If AFSC does not manage its lending program effectively, there is a risk that the program will not sufficiently support the agriculture sector, which may suffer as a result.

AUDIT OBJECTIVE AND SCOPE

The objective of this systems audit was to assess whether AFSC has clearly defined the objectives of its lending program and has systems and processes in place to effectively manage, monitor and measure the performance of the program.

We conducted our field work between October 2015 and April 2016 and substantially completed our audit on May 16, 2016. Our work was conducted in accordance with the *Auditor General Act* and the standards for assurance engagements set out in the CPA Canada Handbook—Assurance.

BACKGROUND

The Alberta Agriculture Development Corporation was created in 1972 and was designed to provide financial assistance to improve the quality of Alberta rural life. The corporation was in operation from 1972 to 1993.

In 1993 the Alberta Agriculture Development Corporation merged with the Alberta Hail and Crop Insurance Corporation and under new legislation formed the Agriculture Financial Services Corporation.

The Alberta Opportunity Company was founded in 1972 and merged into AFSC in 2002. The company provided financial and management assistance to qualified small and medium-sized Alberta businesses that were unable to borrow with reasonable terms from other commercial lenders.

AFSC's lending portfolio has nearly doubled over the last 10 years, growing from $1.01 billion in 2007 to $2.16 billion in 2016, with an accumulated surplus of $18.6 million at March 31, 2016. The following table shows the breakdown of the loan portfolio at March 31, 2016:

LENDING PRODUCT	BALANCE IN THOUSANDS
Farm loans	$1,770,247
Commercial loans	391,219
TOTAL	**$2,161,466**

FINDINGS AND RECOMMENDATIONS

Lack of a clearly defined strategic direction for the lending program

BACKGROUND

Strategic objectives are the steps and accomplishments that an organization completes to achieve its ultimate goal. These objectives help shape and guide what an organization is, what it does and why it does it.

RECOMMENDATION 1: DEFINE STRATEGIC OBJECTIVES, ARTICULATE SECTOR CREDIT NEEDS AND RE-EVALUATE THE RELEVANCE OF THE LENDING PROGRAM

We recommend that the Agriculture Financial Services Corporation:

- clearly define the strategic objectives of the lending program; these objectives should be consistent with AFSC's legislative mandate
- clearly articulate the credit needs of the agriculture sector in Alberta, which should drive its lending activities
- develop a process to periodically re-evaluate the relevance of the lending products it offers to ensure they continue to be relevant

CRITERIA: THE STANDARDS FOR OUR AUDIT

- the lending program should have a clearly defined purpose and strategic objectives
- AFSC should offer lending products that are driven by well-defined agriculture and rural development needs identified through sound analysis

OUR AUDIT FINDINGS

KEY FINDINGS

- AFSC has not clearly defined the strategic objectives for its lending program.
- AFSC has not clearly articulated the credit needs of Alberta's agriculture sector.
- AFSC does not have processes to re-evaluate the relevance of the lending products it offers to ensure they continue to be relevant within a changing environment.

Absence of clearly defined strategic objectives for the lending program

AFSC has not developed clear and specific strategic objectives for its lending program that will shape and guide what lending activities AFSC should undertake.

For the fiscal year 2015–2016, management has set growth targets for the lending products that AFSC offers. In addition, management has set a market share target of 10 per cent of agriculture lending in Alberta within three years.

Growth targets better suit commercial lenders seeking to expand the size and market share of their portfolios. The targets that AFSC has set have little relevance to agriculture development, economic growth or the diversification objectives included in the *Agriculture Financial Services Act*.

The credit needs of the agriculture sector are not clearly articulated

Crown corporations are typically established to resolve a market failure such as a lack of credit for certain businesses or sectors of the economy.

AFSC has not carried out an in-depth analysis to identify the sectors that are underserved by commercial lenders and need encouragement to promote economic development.

The documents that management provided us lacked the following:

- a current state analysis of agriculture lending in Alberta
- roles played by other provincial Crown corporations, such as ATB Financial
- agriculture lending products offered by commercial lenders
- benchmarking of AFSC's lending products against those offered by other lenders to identify gaps and redundancies
- competitive advantages that AFSC has that other lenders do not
- AFSC's limitations given its size and organizational capacity

No systems to periodically re-evaluate the relevance of the lending products

The lending program started in 1972 under AFSC's predecessor companies under substantially different market conditions from today. We noted that AFSC does not have systems to assess how the following changes affect its lending program strategies and product offerings:

- an extended period of low interest rates
- development of insurance programs and other business risk management tools
- an increase in farmland values
- availability of credit through commercial banks and other provincial and federal Crown corporations
- provincial and federal legislation
- industry development

These and other market changes could have a significant impact on the ability of AFSC's lending program to meet the changing needs of the agriculture sector.

IMPLICATIONS AND RISKS IF RECOMMENDATION NOT IMPLEMENTED

Without a clear definition of the purpose of the lending program and its strategic objectives, AFSC's lending activities could easily deviate from its development focus and replicate what other commercial lenders provide, rendering the lending program ineffective.

Department and board oversight of the lending program

BACKGROUND

Oversight is the job of being vigilant, checking that processes and systems, including accountability for results, are working well and signalling preferred behaviour, all in pursuit of desired results.

Oversight responsibilities for Crown corporations do not all rest with a single body. Instead, they are distributed at different levels. For AFSC, oversight responsibilities are shared between:

- the board of directors, which has oversight of AFSC's activities and management
- the responsible minister, who has oversight of the board of directors

AFSC is not a regulated financial services company like federally-regulated, deposit-taking financial institutions that are subject to the supervision of the Office of the Superintendent of Financial Institutions. Nor is it a provincially regulated institution like ATB Financial and Alberta-based credit unions.

Having a robust oversight framework is crucial to any financial institution, and even more so in the absence of external regulatory oversight, as in AFSC's situation.

RECOMMENDATION 2: DEFINE OVERSIGHT RESPONSIBILITIES

We recommend that the Department of Agriculture and Forestry and the board of directors of the Agriculture Financial Services Corporation clearly define the oversight responsibilities of both parties for the lending program.

CRITERIA: THE STANDARDS FOR OUR AUDIT

- oversight responsibilities should be clearly defined and documented
- oversight bodies (the board of directors and the department) are expected to play their respective roles without participating in AFSC's day-to-day management

OUR AUDIT FINDINGS

KEY FINDINGS

- The Department of Agriculture and Forestry did not formally communicate its performance expectations for the lending program to AFSC.
- The former board of directors did not exercise adequate oversight of the lending program in terms of monitoring the performance of and managing the risks associated with the lending program.

Department's oversight

Under the *Alberta Public Agencies Governance Act*, the minister is expected to participate in setting the public agency's long-term objectives and its short-term targets. Further, under Alberta's Public Agencies Governance Framework, the Mandate and Roles Documents, which are jointly prepared between the minister and the board's chair, should outline the goals and performance expectations of the minister.

In the documents we examined, which included the Mandate and Roles Document and the Memorandum of Understanding between the department and AFSC, we found there was no specific communication or consultation on the strategic objectives and the performance expectations for the lending program.

Without clear and agreed upon performance expectations, it can be difficult for AFSC to align its lending activities with the department's strategic direction. Further, it is even more difficult for the department to hold AFSC accountable for achieving targets if there is a lack of clarity around those targets and the associated timelines.

Former board of directors' oversight

The former board of directors did not exercise proper oversight of the lending program in various oversight aspects, namely defining its information needs, monitoring the performance of the program and managing the risks inherent in lending activities.

Information needs

The board did not define the information it needs to provide adequate oversight of the lending program.

Both the board risk committee and the audit committee received periodic reports on the lending program, including information on portfolio composition, level of arrears, and loan loss provisions and methodologies. However, management's reporting lacked the following important information:

- loan portfolio trend analysis
- costs of individual lending products
- analysis of loans originated by other lenders
- analysis of high-risk products, customers or industries
- significant concentrations, including industry, geographic and product concentrations
- risk management reports
- statistics on renegotiated and restructured loans
- stress test results

Review of these reports can help the board identify trends and patterns early and to critically assess and challenge management decisions.

Performance monitoring

The board did not ensure that management developed sound performance measures to assess if the lending program was meeting its objectives.

The lending program's 2015–2016 performance measures proposed by management and approved by the board covered the following areas:

- transaction turnaround time
- loan balances in arrears
- growth in annual lending volumes
- growth in AFSC's market share in agriculture lending

We noted the following with regard to the measures that AFSC has set:

- they were not developed through a structured performance measurement framework that links the resources used by AFSC to the strategic results of the lending program
- they are focused on tasks and activities rather than on results
- they do not cover the full scope of the lending program's objectives

Risk management

The board did not ensure that AFSC has systems to manage the various risks inherent in its lending program.

AFSC does not have a risk management system to identify, rank, mitigate and report risks that could impede it in achieving its strategic objectives. Also, AFSC does not have a risk officer responsible for overseeing risk management.

AFSC does not have an internal credit risk rating system that allows management and the board to monitor the quality of its loan portfolio, identify trends in risk levels and proactively manage credit risk.

AFSC has various risk mitigation controls at the transaction level and recently allocated resources to identify and manage operational risks. However, given the risks associated with its different programs, including lending, we believe that these procedures are inadequate to manage the risks that AFSC is exposed to.

IMPLICATIONS AND RISKS IF RECOMMENDATION NOT IMPLEMENTED

In the absence of proper oversight, Albertans cannot be assured that AFSC is delivering the results expected from its lending program.

Government funding model

BACKGROUND

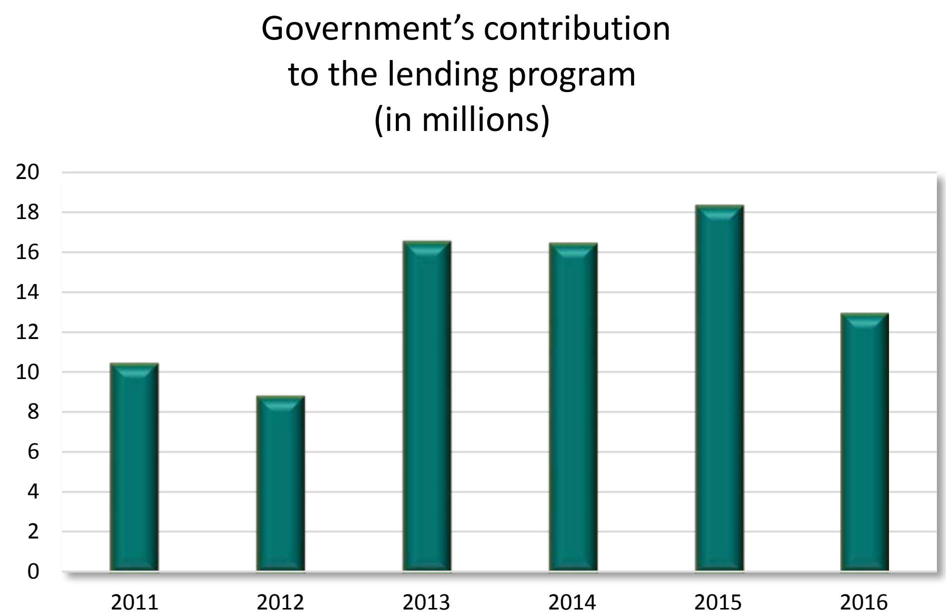
At present, the government provides AFSC with an annual contribution based on the gap between budgeted revenues and expenses of the lending program.

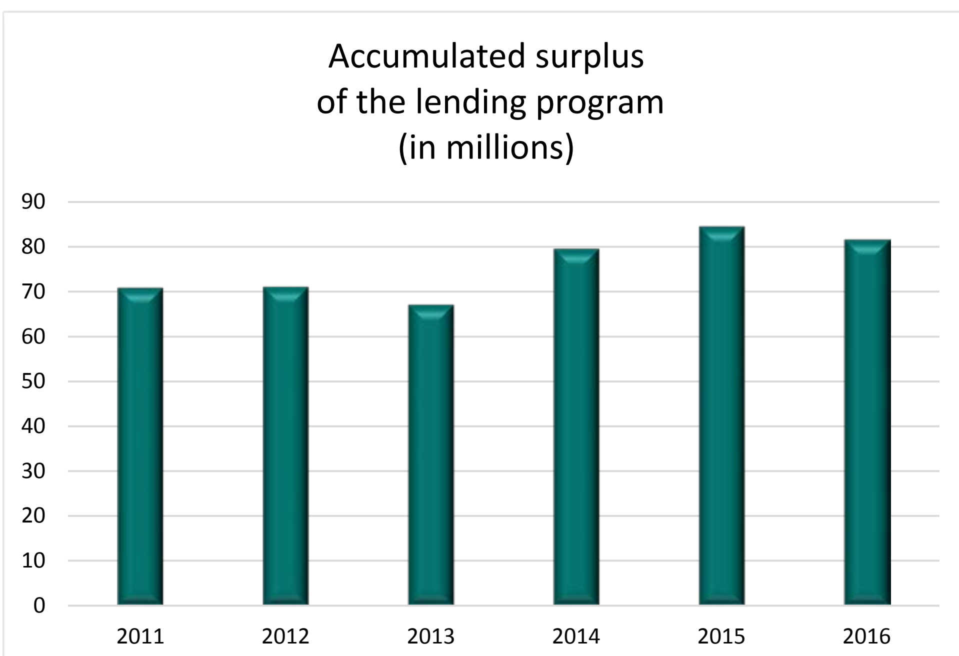
Budgeted revenues include budgeted interest revenue and fees, and budgeted expenses include administration costs (direct and indirect), borrowing costs and estimated provision for loan losses. A significant part of the gap between expected revenues and expenses is attributable to the Beginning Farmer Incentive[1] and costs associated with disaster assistance lending.

Over the years, the lending program has accumulated a surplus primarily because of the difference between actual contributed funding and actual results.

[1] The Beginning Farmer Incentive is a 1.5 per cent rate reduction for the first five years of the loan, up to $500,000.

The following two charts show the government's yearly contribution and the accumulated surplus from the lending program from 2011.





RECOMMENDATION 3: DEVELOP A FUNDING MODEL AND COSTING SYSTEM

We recommend that the Agriculture Financial Services Corporation:

- develop a product-specific government funding model
- develop a costing system capable of allocating, tracking and reporting product-specific costs

CRITERIA: THE STANDARDS FOR OUR AUDIT

AFSC should have:

- a clear funding model that explains which expenses are funded by the government
- a costing system capable of accounting for and reporting product-specific costs

OUR AUDIT FINDINGS

KEY FINDINGS

- The current funding model does not promote accountability for results.
- AFSC does not have a system to track the costs associated with individual lending products.

Under the existing funding model, there is no need or incentive for AFSC to accurately track and report the cost of its individual lending products. As a result, the government does not have sufficient information about what its contribution is used for.

This funding model weakens the accountability relationship between the department and AFSC and makes it difficult for the department to carry out a meaningful cost-benefit analysis to assess if the benefits derived from a specific lending product or initiative exceed what that product or initiative costs Albertans.

IMPLICATIONS AND RISKS IF RECOMMENDATION NOT IMPLEMENTED

In the absence of a clear funding model, the accountability framework and the sustainability of the lending program are hampered.

Absence of an independent function to monitor the loan portfolio

BACKGROUND

The loan portfolio review function assesses whether the credit policy provides adequate guidance for lending activities, determines whether account officers are following loan policy, and provides independent reporting to senior management and the board on the quality of the loan portfolio.

To provide an objective assessment, the loan portfolio review function should be independent of the loan approval process.

RECOMMENDATION 4: MONITOR THE PERFORMANCE OF THE LOAN PORTFOLIO

We recommend that the Agriculture Financial Services Corporation set up an independent function to monitor the performance of the loan portfolio.

CRITERIA: THE STANDARDS FOR OUR AUDIT

AFSC should have an independent function that ensures compliance with established credit policies and procedures, monitors the quality of the loan portfolio, and reports to senior management and the board.

OUR AUDIT FINDINGS

KEY FINDING

AFSC does not have a function independent of the loan approval process to monitor the performance and quality of the loan portfolio.

Currently the credit solutions group at AFSC monitors the activities of credit specialists and compliance with credit policy and procedures. While we consider this monitoring a key control for day-to-day transactions, all people involved in this process are part of the loan approval process and therefore lack the level of objectivity that comes from an independent review.

IMPLICATIONS AND RISKS IF RECOMMENDATION NOT IMPLEMENTED

Without an independent loan review function, AFSC lacks a key monitoring control for its loan portfolio.