

Testimony of the Honorable Leland A. Strom
Chairman and Chief Executive Officer
Farm Credit Administration
Before the Subcommittee on Agriculture,
Rural Development, Food and Drug Administration, and Related Agencies
U.S. Senate Committee on Appropriations
March 31, 2011

Mr. Chairman, Members of the Subcommittee, I am Leland A. Strom, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). On behalf of my colleagues on the FCA Board, Kenneth Spearman of Florida and Jill Long Thompson of Indiana, and all the dedicated men and women of the Agency, I am pleased to provide this testimony.

Before I discuss the Agency's role, responsibilities, and budget request, I would like to thank the Subcommittee staff for its assistance during the budget process. Also, I would respectfully bring to the Subcommittee's attention that the funds used by FCA to pay its administrative expenses are assessed and collected annually from the Farm Credit System (FCS or System) institutions we regulate and examine — the FCS banks, associations, and service corporations, and the Federal Agricultural Mortgage Corporation (Farmer Mac). FCA does not receive a Federal appropriation.

Earlier this fiscal year, the Agency submitted a proposed total budget request of \$62,299,787 for fiscal year (FY) 2012. FCA's proposed budget for FY 2012 includes funding from current and prior assessments of \$62,000,000 on System institutions, including Farmer Mac. Almost all this amount (approximately 82 percent) goes for salaries, benefits, and related costs.

The FY 2012 proposed budget is driven largely by two factors: (1) stress on the System caused by conditions in the agricultural and the general economy and (2) the large number of retirements that FCA anticipates in the coming five years. Although the System remains safe and sound overall, risks have increased across the System, and conditions in several institutions have deteriorated. As a result, we are hiring additional staff members to provide more intensive examination and oversight. We are also hiring employees to fill the positions of those who will be retiring soon. The funding we've requested for FY 2012 will allow us to provide the additional supervision and oversight required in challenging economic times and to ensure that we maintain a staff with the skills necessary to properly examine, oversee, and regulate the System.

MISSION OF THE FARM CREDIT ADMINISTRATION

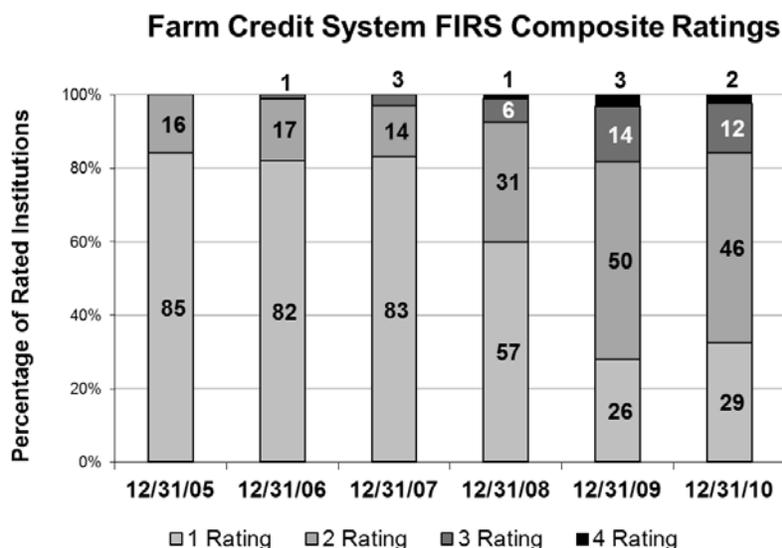
As directed by Congress, FCA's mission is to ensure a safe, sound, and dependable source of credit and related services for agriculture and rural America. The Agency accomplishes its mission in two important ways. First, FCA protects the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and ensures that the institutions comply with applicable laws and regulations. Our examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risk, as well as on the ability of its board and management to direct its operations. We also evaluate each institution's compliance with laws and regulations to ensure that it serves all eligible borrowers, including young, beginning, and small farmers and ranchers. If a System institution violates a law or regulation or operates in an unsafe or unsound manner, we use our supervisory and enforcement authorities to take appropriate corrective action. Second, FCA develops policies and regulations that govern how System institutions conduct their business and interact with customers. FCA's policy and regulation development focuses on protecting System safety and soundness; implementing the Farm Credit Act; providing minimum requirements for lending, related services, investments, capital, and mission; and ensuring adequate financial disclosure and governance. The policy development

program includes approval of corporate charter changes, System debt issuance, and other financial and operational matters.

EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

The Agency's highest priority is to maintain appropriate risk-based oversight and examination programs to ensure the safety and soundness of FCS institutions. Given the increasing complexity and risk in the System and human capital challenges at FCA, we have undertaken a number of initiatives to improve operations, increase examination effectiveness, and enhance staff expertise in key examination areas. The Agency bases its examination and supervision strategies on institution size, existing and prospective risk exposure, and the scope and nature of each institution's business model. FCA also performs nationally focused examinations of specific issues and operational areas to monitor the condition and operations of the System as a whole. On a national level, we actively monitor risks that may affect groups of System institutions or the entire System, including risks from the agricultural, financial, and economic environment.

The frequency and depth of examination activities vary based on risk, but each institution receives a summary of examination activities and a report on its overall condition at least every 18 months. FCS institutions are required to have effective loan underwriting and loan administration processes, to maintain adequate asset-liability management capabilities, and to establish high standards for governance and transparent disclosures for shareholder oversight. Because of the recent increased volatility in the agricultural and credit sectors, FCA has increased its on-site examination presence. Also, FCA is closely watching rapidly rising real estate values in certain sections of the country to ensure that FCS lending practices remain prudent.



Source: FCA's FIRS Ratings Database. The above chart includes only the five System banks and their affiliated direct-lender associations. The figures in the bars reflect the number of institutions by FIRS rating.

In certain cases, FCA will use its enforcement powers to effect changes in the institution's policies and practices to correct unsafe or unsound conditions or violations of law or regulations. The Agency uses the Financial Institution Rating System (FIRS) as a key method to assess the safety and soundness of each FCS institution (see chart above). The FIRS provides a general framework for evaluating significant financial, asset quality, and management factors to assign component and composite ratings. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail. Overall, the System remains financially strong and adequately capitalized. The FCS does not pose material risk to investors in FCS debt, the Farm Credit System Insurance Corporation, or to FCS institution stockholders.

Although the System's condition and performance remain satisfactory overall, a number of FCS institutions are experiencing stress and now require special supervision and enforcement actions. These actions reflect the weaknesses in the Nation's economy and credit markets, a rapidly changing risk environment in certain agricultural segments, and, in certain cases, management's ineffectiveness in responding to these risks. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to those 14 institutions rated 3 or worse. Although these 14 institutions represent less than 4 percent of System assets and do not meaningfully impact the System's consolidated performance, they require significantly greater Agency resources to oversee. As of December 31, 2010, five FCS institutions were under formal enforcement action, but no FCS institutions are in conservatorship or receivership.

REGULATORY AND CORPORATE ACTIVITIES

Regulatory Activities—Congress has given the FCA Board statutory authority to establish policy, prescribe regulations, and issue other guidance to ensure that FCS institutions comply with the law and operate in a safe and sound manner. The Agency is committed to developing balanced, flexible, and legally sound regulations. Some of the Agency's current regulatory and policy projects include the following:

- Revising regulations to implement the requirements of the Dodd-Frank Act
- Revising regulations to ensure that FCS funding and liquidity requirements are appropriate and to ensure that the discounts applied to investments reflect their marketability
- Revising regulations to require that each FCS institution's business plan includes strategies and actions to serve all creditworthy and eligible persons in the institution's territory and to achieve diversity and inclusion in its workforce and marketplace
- Enhancing our risk-based capital adequacy framework to more closely align it with that of other Federal banking agencies and the Basel Accord
- Revising lending- and leasing-limit regulations to ensure that FCS institutions maintain effective policies to measure and manage exposure to single counterparties, industries, and market segments, and to large complex loans
- Revising regulations to allow System institutions to purchase eligible agricultural loans from the Federal Deposit Insurance Corporation
- Revising regulations to enhance System disclosures of senior officer compensation and supplemental benefit programs
- Strengthening investment-management regulations to ensure that prudent practices are in place for the safe and sound management of FCS investment portfolios

Corporate Activities—While the number of FCS institutions has declined over the years as a result of mergers, their complexity has increased, which has placed greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in larger, more cost-efficient, and better-capitalized institutions with a broad, diversified asset base, both by geography and commodity. Thus far in FY 2011, two mergers of associations have become effective. In addition, two banks have submitted a plan of merger for FCA Board consideration. As of January 1, 2011, the System had 84 direct-lender associations, five banks, five service corporations, and two special-purpose entities.

CONDITION OF THE FCS

The System remained fundamentally safe and sound in 2010 and is well positioned to withstand the continuing challenges affecting the general economy and agriculture. Total capital increased to \$33.3 billion at December 31, 2010, up from \$30.0 billion a year earlier. In addition, more than 81 percent of total capital is in the form of earned surplus, the most stable form of capital. The ratio of total capital to total assets increased to 14.5 percent at year-end 2010, compared with

13.9 percent the year before, as strong earnings allowed the System to continue to grow its capital base.

Loan growth picked up in 2010, especially in the second half of the year when commodity prices increased sharply. In total, loans grew by 6.4 percent in 2010 compared with 2.1 percent in 2009. Nonperforming loans decreased modestly to \$3.4 billion as of December 31, 2010, and represented 10.2 percent of total capital at the end of 2010, down from 11.8 percent at the end of 2009. However, although credit quality is satisfactory overall, the volatility in commodity prices and weaknesses in the general economy have increased risks to some agricultural operators, creating the potential for future declines in asset quality.

The System reported significantly higher earnings in 2010, with a combined net income of \$3.5 billion, up 22.6 percent from 2009. Return on assets remained favorable at 1.60 percent. The System's liquidity position equaled 173 days at December 31, 2010, which was essentially unchanged from the 178 days a year earlier and well in excess of the 90-day regulatory minimum. The quality of the System's liquidity reserves also improved in 2010. Further strengthening the System's financial condition is the Farm Credit Insurance Fund, which holds more than \$3.2 billion. Administered by the Farm Credit System Insurance Corporation, this fund protects investors in Systemwide consolidated debt obligations.

Farm income is expected to be very strong in 2011. The U.S. Department of Agriculture forecasts \$98.6 billion in farm net cash income—the highest since 1974, after adjusting for inflation. The high prices that grain, soybean, and cotton farmers will receive for their products will largely account for this increase. High feed costs, however, will present challenges for livestock producers. Already tight supplies of corn and soybeans in the United States could lead to significantly higher feed costs in 2011 and 2012 if growing conditions are unfavorable. High grain prices combined with extremely low interest rates are also propelling farmland values to record highs in parts of the Midwest. Although the current economy supports today's average land prices, some factors, such as higher interest rates, geopolitical developments that could undermine global demand for farm products, and an unexpected decline in grain prices because of a global supply response, could lead to a drop in the value of farm real estate. To address the issue of rising farmland values, FCA organized a meeting with the other Federal financial regulators to discuss concerns and observations regarding agricultural land values and associated risk to loan collateral. Our intent also was to foster a broad-based interchange on the appropriate regulator response to these risks and to develop a productive working relationship among banking regulators. We are considering additional meetings to continue our focus on topics important to agriculture.

The System's access to capital markets returned to normal during 2010, which helped the System further augment its solid overall financial strength, serve its mission, and maintain the Insurance Fund. The System, as a Government-sponsored enterprise (GSE) with solid financial performance, benefitted from monetary policy actions that helped to foster historically low domestic interest rate levels. Tepid investor demand for longer-term Systemwide debt securities in 2009 improved appreciably in 2010, particularly for those with maturities of more than five years. Also, the System continued to enhance its domestic marketing and internal liquidity reserve requirements. For 2011, the System expects that the capital markets will continue to meet all of its financing needs.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Congress established Farmer Mac in 1988 to establish a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac creates and guarantees securities and other secondary market products that are backed by agricultural real estate mortgages and rural home loans, USDA guaranteed farm and rural development loans, and rural utility loans made by

cooperative lenders. Through a separate office required by statute (Office of Secondary Market Oversight), the Agency regulates, examines, and supervises Farmer Mac's operations. Farmer Mac is a GSE devoted to making funds available to agriculture and rural America through its secondary market activities. Under specific circumstances defined by statute, Farmer Mac may issue obligations to the U.S. Treasury Department, not to exceed \$1.5 billion, to fulfill the guarantee obligations on Farmer Mac Guaranteed Securities. Farmer Mac is not subject to any intra-System agreements and is not jointly and severally liable for Systemwide debt obligations. Moreover, the Farm Credit Insurance Fund does not back Farmer Mac's securities.

Farmer Mac made continued financial progress during 2010. Although net income was down significantly from 2009, this decline was largely the result of unrealized gains and losses; however, core earnings, a measure based more on cash flow, was up by 56 percent. As of December 31, 2010, Farmer Mac's core capital totaled \$460.6 million, which exceeded its statutory requirement of \$301.0 million. The result is a capital surplus of \$159.6 million, up from \$120.2 million as of December 31, 2009. The total portfolio of loans, guarantees, and commitments grew 14 percent to \$12.2 billion.

In January 2010, Farmer Mac raised \$250 million in capital from a private offering of shares of noncumulative perpetual preferred stock of Farmer Mac II LLC, an operating subsidiary in which Farmer Mac owns all of the common equity. Farmer Mac used the proceeds to repurchase and retire \$150 million of Farmer Mac's outstanding Series B preferred stock, with additional proceeds available for other corporate purposes. The new preferred stock has a lower net effective cost than the retired capital and has improved Farmer Mac's ability to generate new capital through earnings.

Farmer Mac's program-business portfolio shows stress in certain subsectors but remains manageable. Stress in the ethanol industry, as well as certain crop and permanent planting segments, contributed to an increase in the nonperforming loan rate. The nonperforming loan rate was 1.90 percent at December 31, 2010, compared with 1.41 percent at December 31, 2009. Loans more than 90 days delinquent increased from 1.13 percent at December 31, 2009, to 1.63 percent at December 31, 2010.

Regulatory activity in 2011 that will affect Farmer Mac includes an interagency joint Notice of Proposed Rulemaking to implement provisions of the Dodd-Frank Act relating to capital and margin requirements for over-the-counter derivatives that are not cleared through exchanges; a Notice of Proposed Rulemaking on nonprogram investments and liquidity at Farmer Mac that would, among other things, reduce reliance on credit ratings as required by section 939A of the Dodd-Frank Act; and an Advance Notice of Proposed Rulemaking that will request public input on how to reduce reliance on credit ratings in the methodology underlying the Risk-Based Capital Stress Test. In addition, FCA plans to finalize a rule to update the stress test to address Farmer Mac's new rural utility financing authority and make other technical changes.

CONCLUSION

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System and Farmer Mac remain financially sound and focused on serving agriculture and rural America. It is our intent to stay within the constraints of our FY 2012 budget as presented, and we continue our efforts to be good stewards of the resources entrusted to us. While we are proud of our record and accomplishments, I assure you that the Agency will continue its commitment to excellence, effectiveness, and cost efficiency and will remain focused on our mission of ensuring a safe, sound, and dependable source of credit for agriculture and rural America. This concludes my statement. On behalf of my colleagues on the FCA Board and at the Agency, I thank you for the opportunity to share this information.