Testimony of
The Honorable Nancy C. Pellett
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Mr. Chairman, members of the committee, I am Nancy C. Pellett, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or agency). On behalf of my colleagues on the FCA Board, Doug Flory and Michael Reyna, I am pleased to be here this morning to discuss FCA's oversight of the Federal Agricultural Mortgage Corporation, often referred to as Farmer Mac. Farmer Mac is one of two government-sponsored enterprises (or GSEs), which the FCA regulates, examines, and supervises.

Farmer Mac and the Farm Credit banks and associations are devoted to providing credit and financial services to agriculture and rural America. Our mission at FCA, through these two GSEs, is to ensure that a safe, sound and dependable source of credit is readily available at all times for farmers, ranchers, farmer-owned cooperatives, rural homeowners, and rural America.

This morning I would like to share with you information about FCA and, specifically, its role in the oversight and supervision of Farmer Mac. I will provide you with a brief overview of the organizations, Farmer Mac's current financial condition and risk profile, and recent regulatory and oversight activity affecting Farmer Mac.

THE FARM CREDIT SYSTEM

To add perspective on our regulatory oversight of Farmer Mac, I would like to give you a very brief overview of our role overseeing the Farm Credit System banks and associations (FCS or System). The System has played a prominent role in financing American agriculture and rural America since Congress created the System's first part, the Federal Land Banks, in 1916. The System is the oldest financial GSE in America, and is the only GSE that engages in retail lending. The 108 institutions of the FCS serve all 50 states and the Commonwealth of Puerto Rico. As of December 31, 2003, the System consisted of four Farm Credit Banks and one agricultural credit bank, 97 association lenders, and six subsidiary service corporations. The FCS banks also provide credit to 29 non-System financing institutions, known as OFIs, which include commercial and community banks and their affiliates. At year-end 2003, FCS banks and associations provided services to nearly 450,000 borrowers and held assets of just under $117 billion.

FARMER MAC

Our focus today, however, is on FCA's oversight role of Farmer Mac. Farmer Mac is regulated by FCA through the Office of Secondary Market Oversight (OSMO), which was established in 1992 as required by the Farm Credit Act, as amended. OSMO provides for the examination and general supervision of Farmer Mac's safe and sound performance of its powers, functions, and duties prescribed by the statute. The statute requires that OSMO constitute a separate office within the agency, reporting to the FCA Board and that its activities, to the extent practicable, be carried out by individuals not responsible for the supervision of the banks and associations of the System.

Farmer Mac was created in response to the farm credit crisis of the mid-1980's and subsequent calls from commercial rural bankers for a liquidity source similar to that provided for residential mortgages by the so-called housing GSEs, Fannie Mae and Freddie Mac. Amendments in 1996 to Farmer Mac's authorizing legislation have allowed this GSE to grow its business and achieve economic viability, which was by no means certain in the first few years of its operation. To illustrate that point, the new authorities provided in the Farm Credit System Reform Act of 1996 (1996 Act), helped launch Farmer Mac's first year of positive earnings in that year, when net income was $777,000. Net income generally has risen as rapidly as program growth since then and reached $25 million at year-end 2003, representing a 5-year average annual growth rate of 35 percent while program growth averaged 37 percent over the same period.

Farmer Mac is a stockholder-owned, federally chartered GSE established by Congress to provide a secondary market for agricultural real estate and rural home mortgages. Farmer Mac operates through a network of agricultural lenders, originators, and sellers, among them commercial banks, FCS banks and associations, life insurance companies and mortgage companies. Farmer Mac conducts its business primarily through two core programs, known as Farmer Mac I and Farmer Mac II. Under Farmer Mac I, Farmer Mac purchases, or commits to purchase, qualified loans, or obligations backed by qualified loans, that are *not* guaranteed by any instrumentality or agency of the United States. Under Farmer Mac II, Farmer Mac purchases the guaranteed portions of farm ownership and farm operating loans, rural business and community development loans, and certain other loans guaranteed by USDA.

Farmer Mac has three classes of common stock:

1. *Class A Voting Common Stock* which may only be held by banks, insurance companies, and other financial institutions that are not institutions of the FCS. By statute, no owner of Class A stock may hold more than 33 percent of the outstanding shares of Class A stock. At year-end 2003, one Class A stockholder, Zions Bancorporation, held over 31 percent (2 percentage points under the statutory limit). There are just over one million shares of Class A common stock outstanding.

2. *Class B Voting Common Stock* which may only be held by institutions of the FCS and are not exchange-traded. There are no restrictions on the maximum purchase or holdings of Class B stock. Major Class B common stockholders of the FCS include: AgriBank, FCB, St. Paul, MN, (40 percent); U.S. AgBank, FCB, Wichita, KS, (20 percent), and AgFirst Farm Credit Bank, Columbia, SC, (17 percent). There are just over 500,000 Class B shares issued and outstanding.

3. *Class C Non-Voting Common Stock* which has no ownership restrictions. The top holders of Class C non-voting stock is Zions Bancorporation (14.6 percent) as of April 9, 2004, the record date for Farmer Mac's most recent notice of annual meeting. Together, all Farmer Mac directors and executive officers owned 26.9 percent of Class C shares. Outstanding shares of Class C common stock were just over 10.5 million at year-end.

Class A and Class C common stock are traded on the New York Stock Exchange

(NYSE) under the symbols “AGMa” for Class A and “AGM” for Class C shares.

The Farmer Mac Board of Directors (Board) is comprised of 15 members according to the statute. Five are elected by Class A common stock shareholders. Five are elected by holders of Class B common stock. The President of the United States appoints the remaining five, and one of these is appointed by the President as chairman. The Board has organized several standing committees and appoints other ad-hoc committees, which oversee Farmer Mac’s management and operations.

The recent General Accounting Office (GAO) report noted the potential difficulty Farmer Mac could have complying with the independence requirements in NYSE listing standards. Notably, in response to this, the Farmer Mac Board and, in particular, the Audit Committee have increased their activity in the areas of independent review and reporting processes in recent months.

Farmer Mac’s daily operations are led by its President and Chief Executive Officer (CEO) and a core team of five vice-presidents made up of the Chief Financial Officer, General Counsel, Controller, Vice President of Agricultural Finance (primarily a marketing/business development position), and the recently created position of Vice-President of Mortgage Servicing. The Corporation employs 36 people and all but one are located at the Washington, D.C. headquarters.

FINANCIAL HIGHLIGHTS

For the year ended December 31, 2003, Farmer Mac’s net worth increased 16 percent to $213 million, up from $183.5 million at year-end 2002. Capital available to meet minimum and regulatory requirements were well above levels prescribed by the statute and FCA regulations. The minimum core capital required by statute was $142 million. Core capital available to meet this requirement was $216 million. Risk-based regulatory capital required at year-end 2003 was $39 million. Regulatory capital available to meet this requirement was $238 million.

Operations and Program Portfolio

Net income for the year was $25 million, an 18 percent increase over 2002. However, core earnings were relatively flat.

Loan purchase and credit guarantee activity grew just under 5 percent to $5.8 billion from $5.5 billion at year-end 2002. Liquidity investments were $1.7 billion, up nearly 9 percent from a year earlier.

Farmer Mac’s Long-term Standby Purchase Commitment (Standby) program has become a significant part of its operations. Standby’s essentially are a guarantee of loans that are not purchased by Farmer Mac unless a specific event, such as a default of the loans, trigger such a response. Standby volume outstanding totaled $2.3 billion at the end of December 2003 and now represents over 40 percent of all (off- and on-balance sheet) Farmer Mac program activity.

Portfolio Risk

Nonperforming asset volume at year-end 2003 amounted to 1.39 percent of post-1996 program volume outstanding, compared to 1.56 percent at December 31, 2002. These assets are measured against post-1996 activity because of the negligible risk in loans underlying assets acquired before the 1996 legislative changes. The downward trend in nonperforming loans and delinquencies appears to be continuing in 2004.

The allowance for losses, the first buffer to Farmer Mac's capital from loan losses, was $22.1 million at year-end 2003, compared to $20.0 million as of December 31, 2002. Charge-offs on loans and real estate-owned during 2003 were $5.2 million, up from $4.1 million in 2002 and $2.2 million in 2001. In contrast, there were no charge-offs in 2000. Working with Farmer Mac and Farmer Mac's outside accounting firm, FCA monitors charge-off activity.

REGULATORY ACTIVITY

FCA examines and supervises Farmer Mac through authorities granted by Title VIII of the Farm Credit Act of 1971, as amended. As part of FCA's oversight program, the agency requires Farmer Mac to report quarterly on financial performance consistent with regulatory requirements that are similar to the quarterly Call Reports required by other federal financial regulators. The agency promulgates regulations, examines all books and records, and ensures safe and sound operations of Farmer Mac through regulatory enforcement powers that are comparable with other federal financial regulators, though somewhat broader in the area of receivership authority than that of our counterpart, the Office of Federal Housing Enterprise Oversight (OFHEO). FCA, in contrast to OFHEO, has clear statutory authority to establish receivership regulations for the institutions it regulates, including Farmer Mac. The FCA has had receivership regulations in place for Farmer Mac since 1997. The statute provides the FCA Board broad enforcement powers. These powers are comparable to other federal financial regulators such as the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

Unlike Fannie Mae and Freddie Mac, by statute, Farmer Mac must register with the Securities and Exchange Commission (SEC) and as a publicly traded corporation, also must comply with NYSE listing standards and requirements. As a publicly traded entity and SEC registrant, regulatory reporting and disclosure requirements are significant matters demanding constant vigilance for compliance by Farmer Mac's compliance officer, executive management, and Board.

Examination and Supervision

The statute requires FCA to examine Farmer Mac's operations once each year. In practice, FCA monitors activities and requires reports from all institutions it regulates on an on-going basis, including Farmer Mac. We combine our offsite review and follow-up activities with onsite testing and verification procedures and produce an annual report of examination. OSMO and FCA examiners regularly meet with the Farmer Mac Board and executive management to discuss and resolve examination findings and recommendations and to ensure required regulatory reporting is accurate and appropriate.

Consistent with past practice and for safety and soundness reasons, FCA does not make public (1) institution-specific examination findings and recommendations, nor (2) enforcement actions taken against institutions it supervises. Therefore, I may not be able to fully address certain questions in open session that would pertain to examination findings or FCA's supervisory activities resulting from the examination. Ongoing monitoring and oversight activities resulting from examination findings and recommendations are conducted through OSMO and are independent and separate from the oversight activities affecting other institutions of the Farm Credit System.

The FCA has increased examination and oversight activities of Farmer Mac over the past 2 years. Numerous meetings and follow-up discussions have occurred with the Farmer Mac Board and management during 2003 as results from the 2002 examination were being addressed and as the 2003 examination was conducted. Examination scopes, both breadth and depth, were expanded significantly. Examiner resources applied to Farmer Mac's oversight more than tripled from FY 2001 to those used during FY 2003. Use of outside consultants to assist OSMO in the examination and oversight of Farmer Mac also increased, including securing an outside accounting firm to advise and assist FCA examiners as the 2003 examination was completed.

Throughout 2003, agency offsite monitoring and follow-up activities with Farmer Mac's Board and management increased significantly over prior years. FCA's increased examination and oversight activities respond specifically to the GAO report recommendations. Additional permanent budgeted resources also were increased for OSMO. In October 2002, a full-time Senior Policy Analyst was added to OSMO's staff, and an Associate Director for Examination and Supervision is planned for FY 2004.

The most recent examination was concluded in December 2003. The examination was comprehensive, risk-based, and focused on what is referred to by federal financial regulators as a "CAMELS" assessment. A CAMELS assessment includes an in-depth analysis of the institution's Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risks. The 2003 examination also included an in-depth evaluation of Farmer Mac's information technology, internal controls, and accounting treatment for nonperforming loans and real estate owned. We presented the agency's 2003 Report of Examination to the Farmer Mac Board at its February 2004 meeting and OSMO actively continues to follow-up with the Board, the Board's Audit Committee, and executive management.

CHALLENGES FOR THE FUTURE

The GAO Report issued in October 2003 included five recommendations for enhanced oversight of Farmer Mac by FCA. In addition to activities that were already underway while the GAO was conducting their study, the agency has taken action on several fronts in response to the GAO report, among which are the following:

1. Non-Program Investment and Liquidity Proposed Rule—This proposed rule was approved by the FCA Board on April 22, 2004. Publication in the Federal Register is expected in June with a comment period of 90 days. The proposed rule would set limits, both minimum and maximum, on the amount and type of non-program liquidity investments that Farmer Mac would be permitted to hold. While GAO had no specific recommendations for FCA regarding Farmer Mac's liquidity, we believe the proposed rule will help address the issues raised in the report with regard to liquidity planning and mission focus by Farmer Mac.

2. Revised Risk-Based Capital Standards—We have a workgroup actively engaged in the development of a second proposed rule, which we expect will revise numerous aspects of the Risk-based Capital (RBC) Stress Test. The RBC stress test is required by statute and is used to calculate the amount of minimum regulatory capital required by Farmer Mac. By this fall, we expect the workgroup to provide recommendations to the FCA Board regarding any additional regulatory requirements for Farmer Mac to consider in the application of the RBC test and capital adequacy planning. I would also note that we are giving full consideration to the recommendations by GAO for the RBC stress test.

3. Offsite Monitoring and Reporting Requirements—Initial revisions to the Farmer Mac quarterly call reports (Call Reports) were implemented in March 2004, including conversion from hardcopy to electronic submission format, as well as numerous adjustments to Call Report schedules, some of which were specifically recommended by GAO in their comments regarding offsite monitoring of Farmer Mac. We are also evaluating the need for additional revisions or expansion of schedules, which will be implemented in 2005. Other reporting requirements have been implemented also. For example, OSMO recently required a detailed position-level report on Farmer Mac's debt issuances, derivatives, and liquidity investments that are received on a more frequent schedule than the quarterly Call Reports. We believe these enhanced reporting requirements are necessary for the on-going oversight of Farmer Mac's operations and go beyond the recommendations provided by the GAO report.

4. Credit Rating Requirement for Farmer Mac—FCA has initiated work and committed resources for an analysis and evaluation of different approaches used by other GSE regulators that require their regulated entities to obtain credit ratings. We have asked staff to present options and recommendations to the FCA Board regarding GAO's recommendation on this matter. We have also requested staff to consider other activities currently underway at the agency and at Farmer Mac that may affect the need for the agency to promulgate formal rules in this area.

5. Assessment of Farmer Mac's Impact on the Real Estate Market—The GAO report recommended we conduct an assessment of Farmer Mac's impact on the agricultural real estate market. The GAO report also suggested Congress clarify the statute with regard to Farmer Mac's mission. Staff has begun planning for this recommendation and will consider different approaches for conducting this assessment. Meanwhile, OSMO is developing a special "Mission Call Report" to help track Farmer Mac's success in achieving its mission as currently defined in statute.

I would like to note that FCA supports the suggestions to Congress made in the GAO report. In particular, we support greater flexibility for the regulator to design and set minimum and regulatory capital standards in addition to those established by the Risk-Based Capital Stress Test. This would be consistent with authority granted to other financial institution regulators and our own authority to regulate capital needed by the Farm Credit System banks and associations.

CONCLUSION

Farmer Mac has made progress since the 1996 legislative changes. Capital has increased to $213 million at year-end 2003 from $47 million at year-end 1996. Program growth has been robust impacting Farmer Mac's risk profile and challenging management, operational systems, and internal controls. Both Farmer Mac and FCA are actively working to ensure these challenges are met.

In conclusion, Mr. Chairman, let me say that we are committed to Farmer Mac's success and the achievement of its statutory purpose as a Congressionally-chartered GSE serving agriculture and rural America. It must be safe and sound at all times to do so. FCA continues to enhance its regulatory oversight of Farmer Mac, and I believe we are well positioned to address any challenges to ensure Farmer Mac has the capability to remain successful in the future. We remain committed to that goal and the achievement of our mission, "to ensure a safe, sound and dependable source of credit for agriculture and rural America."

Thank you for the opportunity to be here today and for your continued support of FCA and our mission of service to agriculture and rural America. I will be pleased at this time to answer any questions.