

Testimony of the Honorable Jill Long Thompson
Chair and Chief Executive Officer
Farm Credit Administration
Before the Subcommittee on Agriculture,
Rural Development, Food and Drug Administration, and Related Agencies
U.S. House of Representatives Committee on Appropriations
February 2, 2015

Mr. Chairman and Members of the Subcommittee, I am Jill Long Thompson, Board Chair and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). On behalf of my colleagues on the FCA Board, Kenneth A. Spearman of Florida and Leland A. Strom of Illinois, 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, it is my privilege to thank the Subcommittee staff for its assistance during the budget process. As the Subcommittee knows, FCA does not receive a Federal appropriation. The funds used by FCA to pay its administrative expenses are assessed and collected annually from the Government-sponsored enterprises we regulate and examine—the Farm Credit System (FCS or System) made up of banks, associations, and service corporations, and the Federal Agricultural Mortgage Corporation (Farmer Mac).

The Agency is submitting a proposed total budget request of \$69,400,000 for fiscal year (FY) 2016. FCA's proposed budget for FY 2016 includes funding from current and prior-year assessments of \$68,800,000 on System institutions, including Farmer Mac, and \$600,000 from anticipated reimbursable work for the Farm Credit System Insurance Corporation, the U.S. Department of Agriculture, and the National Consumer Cooperative Bank. Almost all this amount—84.4 percent—goes for salaries, benefits, and related personnel costs.

A key factor driving the FY 2016 budget is the Agency's need to hire and train qualified individuals to replace the many employees—especially examiners—who have begun to retire. We must ensure that our staff has the skills it needs to address changes in the agricultural industry and the complexities of agricultural finance. Also, changes in the organization and structure of the System itself are presenting challenges. As System institutions continue to merge and grow larger and more complex, the Agency must dedicate more resources to acquire technology and hire skilled staff to examine and oversee these institutions. The funding we have requested for FY 2016 will allow us to hire, train, and retain the people we need 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 all creditworthy, eligible persons in 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 risks, 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 and evaluate whether 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 ensure appropriate corrective action is taken. 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

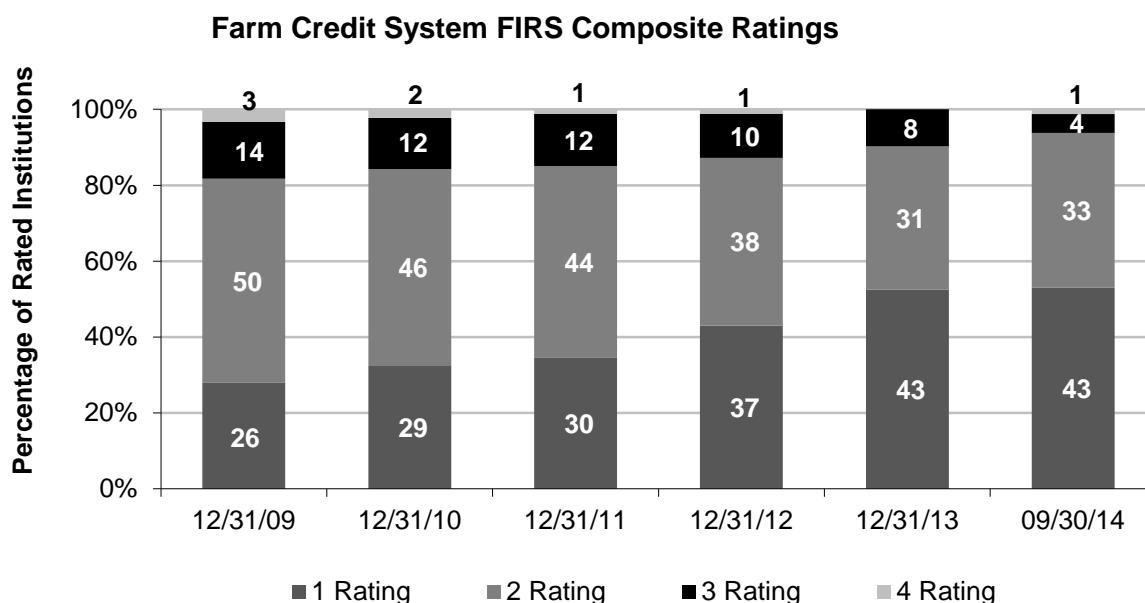
disclosure and governance. The policy development program includes approval of corporate charter changes, System debt issuance, and other financial and operational matters.

EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

To help ensure the safety and soundness of FCS institutions, FCA uses examination and supervision processes to address material and emerging risks at the institution level and across the System. 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. We monitor agricultural, financial, and economic risks that may affect groups of institutions or the entire System. Given the increasing complexity and risk in the System and human capital challenges at FCA, we continue to implement a number of initiatives to improve operations, increase examination effectiveness, and enhance staff expertise in key examination areas.

The frequency and depth of examination activities vary based on risk, but each institution is examined at least once every 18 months and receives a summary of examination activities and a report on its overall condition. FCS institutions are required to have effective loan underwriting and loan administration processes, to properly manage assets and liabilities, to establish high standards for governance, and to provide transparent disclosures to shareholders. FCA's examination and supervision program promotes accountability in FCS institutions by working to ensure institutions identify and manage risks. In addition, FCA is closely watching real estate values that have risen rapidly in certain sections of the country in light of significant volatility in certain crop prices. FCA may use its enforcement powers to effect changes in an institution's policies and practices to correct unsafe or unsound conditions or violations of law or regulations.

The Agency uses its Financial Institution Rating System (FIRS) to assess the safety and soundness of each FCS institution. The system provides a framework of component and composite ratings to help examiners evaluate significant financial, asset quality, and management factors. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail. As the chart below indicates, the System remains financially strong overall. At the present time, institutions are well capitalized, and the FCS does not pose material risk to investors in FCS debt, the Farm Credit System Insurance Corporation, or to FCS institution stockholders.



Source: FCA's FIRS Ratings Database. The above chart includes only the System banks and their affiliated direct-lender associations. It does not include Farmer Mac. The figures in the bars indicate the number of institutions by FIRS rating.

Although the System's condition and performance remain satisfactory overall, several institutions are experiencing stress that requires special supervision and, in some cases, enforcement actions. Factors causing the stress include weaknesses in the Nation's economy and credit markets, a rapidly changing risk environment in certain agricultural segments, and, at times, management's ineffective response to these risks or other operational challenges. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to the five institutions rated 3 or worse. Although these institutions represent less than one percent of System assets and do not materially affect the System's consolidated performance, they require significantly greater Agency resources to oversee. As of September 30, 2014, three FCS institutions were under formal enforcement actions, 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. Current regulatory and policy projects include the following:

- Revising the capital regulations to make them consistent with Basel III, as appropriate
- Revising regulations on flood insurance to conform to the Biggert-Waters Flood Insurance Reform Act of 2012
- Revising regulations on eligibility and creditworthiness of FCS institution investments
- Clarifying and strengthening standards-of-conduct regulations
- Clarifying and enhancing voting procedures related to tabulating votes, using teller committees, and handling ballots
- Revising regulations related to FCS bank and association mergers and consolidations
- Revising regulations on eligibility and creditworthiness of Farmer Mac investments
- Revising the corporate governance requirements for Farmer Mac

Corporate Activities—Because of mergers, the number of FCS institutions has declined over the years, but their complexity has increased, placing greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in more cost-efficient and better-capitalized institutions with broader, more diversified asset bases, both by geography and commodity. As of January 1, 2015, the System had 76 direct-lender associations, four banks, five service corporations, and two special-purpose entities.

CONDITION OF THE FCS

The System remained fundamentally safe and sound in 2014 and is well positioned to withstand the continuing challenges affecting the general economy and agriculture. Total Generally Accepted Accounting Principles (GAAP) capital increased to \$45.8 billion at September 30, 2014, up from \$41.7 billion a year earlier. The ratio of total capital to total assets increased to 16.9 percent at September 30, 2014, compared with 16.5 percent the year before, as strong earnings allowed the System to continue to grow its capital base. Total GAAP capital includes the Farm Credit Insurance Fund of about \$3.7 billion, which is restricted capital. The Fund is administered by the Farm Credit System Insurance Corporation, which is an independent Government-controlled corporation established by Congress to insure the timely payment of principal and interest on Systemwide and consolidated debt obligations.

The System experienced moderate loan growth this past year. There was a 7.1 percent increase in the System's outstanding loans from September 2013 to September 2014. Real estate loans rose 4.5 percent during the period, while production loans rose 5.7 percent. Nonperforming loans decreased modestly to \$1.8 billion at the end of FY 2014, representing 3.9 percent of total capital, down from 5.4 percent a year earlier.

The FCS earned \$3.6 billion in the first nine months of 2014, a 2.0 percent increase from the same period in 2013. Return on assets remained favorable at 1.3 percent during this period. The System's liquidity position decreased to 174 days as of September 30, 2014, from 194 days at the end of 2013, but remained significantly above the 90-day regulatory minimum. The quality of the System's liquidity reserves also improved in 2014.

The System, while continuing to record strong earnings and capital growth, remains exposed to a variety of risks associated with its portfolio concentration in agriculture and rural America. Grain and oilseed prices fell below four-year lows as USDA is projecting record large harvests for 2014. This decline is largely due to farmers enjoying mostly favorable growing conditions for two consecutive years on their large planted acres. Grain and soybean producers are facing the likelihood of leaner profit margins in 2015.

While lower grain prices significantly reduce the near-term financial prospects for crop producers, they have been beneficial to the protein, dairy, and ethanol industries. After struggling with high input costs the past several years, these industries are now looking forward to a more favorable profitability outlook. The agricultural sector remains subject to future risks such as a significant farmland price correction, a rise in interest rates, weather-related catastrophes, and volatility in worldwide demand for agricultural products. The housing sector continues to improve, albeit at a slow pace, and should translate into improved credit conditions for the housing-related sectors such as timber and nurseries.

The System benefited from long-standing domestic accommodative monetary policies and persistent global economic weakness which continued to foster low interest rates. Investor demand for System debt has remained favorable across the yield curve. Although interest rates did fluctuate higher at various times, overall risk premiums continued to be very favorable on newly issued System debt. Also, the System was able to exercise the options on a significant quantity of callable bonds as interest rates fluctuated, however, to a much reduced extent than FY 2013. Going forward, expectations for higher interest rates are building. Despite this development, the System fully expects the capital markets will continue to meet its financing needs.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Congress established Farmer Mac in 1988 to create a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac has authority to create and guarantee 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 cooperative loans. Through a separate office mandated by statute (Office of Secondary Market Oversight), the Agency regulates, examines, and supervises Farmer Mac's operations.

Farmer Mac is committed to enhancing the availability of reasonably priced credit 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's financial condition improved during 2014 with two significant issuances of high-quality equity capital totaling \$146 million. GAAP net income was down from FY 2013 due

primarily to unusually high unrealized gains on derivative positions in the prior year. However, core earnings, a measure based more on cash flow, were up by 8.0 percent over FY 2014 to \$55.3 million. As of September 30, 2014, Farmer Mac's core capital totaled \$761.3 million, which exceeded its statutory requirement of \$332.9 million. The total portfolio of loans, guarantees, and commitments grew 1.6 percent to \$14.0 billion.

Credit quality trends remained favorable and credit quality in all program business lines remained satisfactory. Credit risk was manageable as adversely classified volume declined and the percentage of acceptable loan volume increased, while delinquencies remained low. As of September 30, 2014, substandard loans were 2.4 percent of total direct credit exposure, compared with 3.8 percent a year earlier. Loans more than 90 days delinquent remained low, declining to 0.46 percent from 0.66 percent the year prior.

CONCLUSION

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System, including Farmer Mac, remains financially sound and focused on serving agriculture and rural America. It is our intent to stay within the constraints of our FY 2016 budget as presented, and we continue our efforts to be good stewards of the resources entrusted to us. In addition, we have met all of the requirements of the GPRA Modernization Act that apply to our Agency. Our budget proposal identifies our goals and the performance measures we have developed to help ensure that we use our resources efficiently and effectively. We are proud of our record and accomplishments; and 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.