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. House of Representatives Committee on Appropriations
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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 $64,130,601 for fiscal year (FY) 2013. FCA's proposed budget for FY 2013 includes funding from current and prior assessments of $63,300,000 on System institutions, including Farmer Mac. Almost all this amount (approximately 83 percent) goes for salaries, benefits, and related costs.

A key factor driving the FY 2013 budget is the Agency's need to hire and train qualified individuals to replace the many employees who are expected to retire soon. 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. On January 1, 2012, two System banks merged, representing the largest merger in the history of the FCS. As System institutions continue to merge and grow larger and more complex, the Agency must dedicate more resources to examining and overseeing these institutions. The funding we have requested for FY 2013 will allow us to hire and train the people we need to continue to properly examine, oversee, and regulate the System.

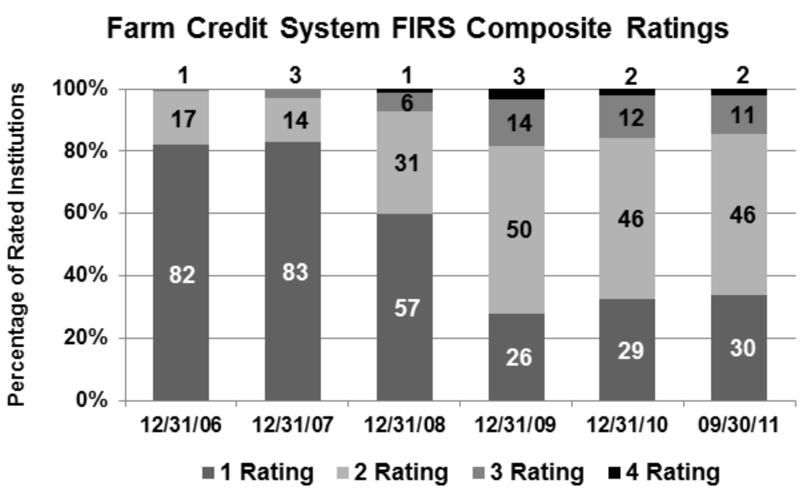
MISSION OF THE FARM CREDIT ADMINISTRATION

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

To help ensure the safety and soundness of FCS institutions, FCA uses examination and supervision processes to address material risks and emerging issues 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 have undertaken 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 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 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 providing a framework to help institutions identify and manage risks. In addition, FCA is closely watching rapidly rising real estate values in certain sections of the country to ensure that FCS lending practices remain prudent. 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.



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

The Agency uses the 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 above indicates, the System remains financially strong overall. 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.

Although the System's condition and performance remain satisfactory overall, several institutions are experiencing stress and now require special supervision and 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, in certain cases, management's ineffective response to these risks. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to those 13 institutions rated 3 or worse. Although these institutions represent about 2 percent of System assets and do not meaningfully affect the System's consolidated performance, they require significantly greater Agency resources to oversee. As of December 31, 2011, seven 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. 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 make it more consistent with the Basel Accord and with that of other Federal financial regulating authorities
- Revising regulations to enhance System disclosures and compliance requirements for executive compensation, pension, and other benefit programs
- Strengthening investment-management regulations to ensure that prudent practices are in place for the safe and sound management of FCS investment portfolios
- Revising regulations to provide guidance on the statutory and regulatory authority related to rural community investments
- Revising regulations to provide the parameters under which an FCS institution may organize or invest in LLCs, LLPs, and other unincorporated business entities
- Clarifying and strengthening standards-of-conduct regulations
- Revising regulations related to FCS bank and association mergers and consolidations

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 larger, more cost-efficient, and better-capitalized institutions with a broad, diversified asset base, both by geography and commodity. Thus far in FY 2012, two banks have merged, and two associations have merged. In addition, a new service corporation was chartered. As of January 1, 2012, the System had 83 direct-lender associations, four banks, six service corporations, and two special-purpose entities.

CONDITION OF THE FCS

The System remained fundamentally safe and sound in 2011 and is well positioned to withstand the continuing challenges affecting the general economy and agriculture. Total capital increased to $35.9 billion at September 30, 2011, up from $33.0 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 15.8 percent at September 30, 2011, compared with 15.0 percent the year before, as strong earnings allowed the System to continue to grow its capital base.

Because of stronger agricultural profits, which reduced the need for farmers to borrow, the System experienced slower loan growth. In total, gross loans grew by 1.3 percent over the 12-month period ended September 30, 2011, compared with 3.9 percent during the previous period. Nonperforming loans decreased modestly to $3.3 billion at the end of FY 2011, representing 9.2 percent of total capital, down from 11.3 percent a year earlier. However, although credit quality has been improving and is satisfactory overall, volatility in commodity prices, rising input prices, and weaknesses in the general economy pose continued risks to some agricultural operators, creating the potential for a reversal of this trend.

The FCS earned $3.0 billion in the first nine months of 2011, a 13.7 percent increase from the same period in 2010. Return on assets remained favorable at 1.7 percent. The System's liquidity position increased from 172 days as of September 30, 2010, to 200 days a year later, remaining significantly above the 90-day regulatory minimum. The quality of the System's liquidity reserves also improved in 2011. Further strengthening the System's financial condition is the Farm Credit Insurance Fund, which holds almost $3.4 billion. Administered by the Farm Credit System Insurance Corporation, this fund protects investors in Systemwide consolidated debt obligations.

U.S. agriculture just experienced back-to-back years of exceptional profitability. According to U.S. Department of Agriculture estimates, combined net farm income for 2010 and 2011 is 23 percent higher than for 2008 and 2009. Higher farm incomes reflect rising prices for key crops. However, farm prosperity has not been uniform—because of high feed costs, profits were lower for livestock producers than for crop producers. Despite continued financial stress among certain livestock enterprises, such as dairy, farm finances were generally strong going into 2012. While many farmers have significantly increased capital investments, they have done so using excess cash and limited their use of credit. For those farmers borrowing money, they are paying some of the lowest interest rates of their lifetime.

U.S. farm incomes for 2012 may well hinge on the ability of farmers across the globe to expand production enough to alleviate tight world stocks of key crops. Greatly improved weather and higher plantings could turn shortages of key crops such as corn and soybeans into surpluses quickly, thus causing prices to fall. Meanwhile, future world economic growth and, hence, food demand, remains uncertain, as does the exchange value of the dollar and government policies that affect agriculture and energy. As a result, commodity prices will probably remain volatile.

An increasing risk to the farm sector's financial health is the persistent rise in production costs. The surge in farmland prices and rental rates have driven production costs even higher, especially over the past two years. This is most notable in the Midwest where corn and soybeans are the main enterprises. In some states, farmland prices now significantly exceed inflation-adjusted records. These prices could drop significantly if grain prices fall or interest rates climb. While the percentage of debt being used to purchase land appears to be modest, FCA continues to closely monitor farmland values and associated risk to loan collateral across the System. In addition, FCA continues to exchange ideas and meet with other banking regulators to determine the most appropriate regulator response to risks associated with rising land values.

The System had full access to the capital markets during 2011, which further increased its overall financial strength and its ability to serve its mission. In addition, as a Government-sponsored enterprise (GSE), the System has benefitted from the monetary policies that have helped foster historically low interest rates. Despite continued volatility in the financial markets, investor demand for System debt has remained favorable across the yield curve. Because of low interest rates, the System was able to exercise the options on significant quantities of callable bonds to further reduce the cost of funds. For 2012, the System expects that the capital markets will continue to meet 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 financial progress during FY 2011. Although GAAP net income was down from 2010, this decline was largely the result of unrealized gains and losses; however, core earnings, a measure based more on cash flow, was up by 50 percent. As of September 30, 2011, Farmer Mac's core capital totaled $461.3 million, which exceeded its statutory requirement of $336.6 million. The result is a capital surplus of $124.7 million, down from $183.2 million as of September 30, 2010. The total portfolio of loans, guarantees, and commitments grew 3.2 percent to $11.8 billion.

Farmer Mac's program-business portfolio shows stress in certain subsectors, but credit risk 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 1.46 percent at September 30, 2011, compared with 1.86 percent a year earlier. Loans more than 90 days delinquent decreased from 1.53 percent at September 30, 2010, to 1.02 percent a year later.

Regulatory activity in 2012 that will affect Farmer Mac includes an interagency joint final 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 final rulemaking on nonprogram investments and liquidity at Farmer Mac; a proposed rulemaking to amend regulatory requirements governing operating and strategic planning; and a proposed rulemaking to amend the Risk-Based Capital Stress Test to reduce its reliance on credit ratings.

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 2013 budget as presented, and we continue our efforts to be good stewards of the resources entrusted to us. In addition to appointing a Performance Improvement Officer, we have met all of the other 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 judiciously. 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.