Testimony of the Honorable Kenneth A. Spearman
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
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Mr. Chairman and Members of the Subcommittee, I am Kenneth A. Spearman, Board Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). On behalf of my colleagues on the FCA Board, Dallas P. Tonsager of South Dakota and Jeffery S. Hall of Kentucky, 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, the Federal Farm Credit Banks Funding Corporation, and the Federal Agricultural Mortgage Corporation (Farmer Mac).

The Agency is submitting a proposed total budget request of $70,400,000 for fiscal year (FY) 2017. FCA's proposed budget for FY 2017 includes current and prior-year assessments of $69,800,000 from 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—83.7percent—goes for salaries, benefits, and related personnel costs.

A key factor driving the FY 2017 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. Furthermore, we must increase the use of technological and data tools used by Agency staff. The funding we have requested for FY 2017 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.

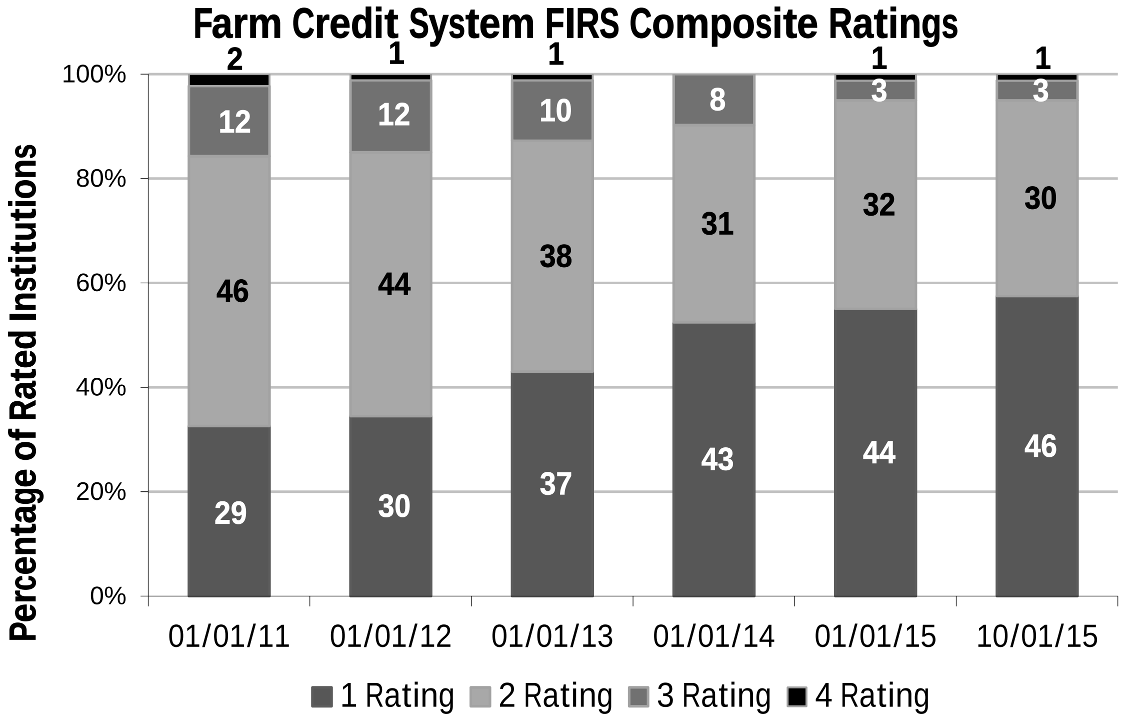
EXAMINATION PROGRAMS FOR FCS BANKS AND ASSOCIATIONS

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 as lower grain prices and the expectation of a rise in long-term interest rates weigh on land prices in certain sections of the country. 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 on the following page 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.

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 four 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, 2015, three FCS institutions were under formal enforcement actions, but no FCS institutions are in conservatorship or receivership.



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.

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 private flood insurance provisions of 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 or changing the amortization limits for agricultural credit associations and production credit associations.
- 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, 2016, the System had 74 direct-lender associations, four banks, five service corporations, and two special-purpose entities.

Condition of the FCS

The FCS remains fundamentally safe and sound and is well positioned to withstand the challenges facing U.S. agriculture during the current cyclical downturn. The depth and duration of this cyclical downturn is unknown, which will continue to present challenges for the System until markets rebound. While the current credit stress level in the System's loan portfolio is well within its risk-bearing capacity, asset quality is expected to decline modestly in 2016 from relatively strong levels in 2015. Supporting the overall condition of the FCS is moderate loan growth, adequate capital, and reliable access to debt capital markets.

The System continues to grow at a moderate pace. As of September 30, 2015, gross loans totaled $226.8 billion, up $18.8 billion or 9.0 percent from September 30, 2014. Real estate mortgage lending was up $7.0 billion or 7.2 percent as demand for cropland continued in 2015. Overall, real estate mortgage loans represent 45.7 percent of the System's loan portfolio. Production and intermediate-term lending increased by $2.9 billion or 6.4 percent from the year before, and agribusiness lending increased by $4.2 billion or 13.9 percent.

The System also continues to enhance its capital base, which strengthens its financial position as low or negative farm returns increase financial stress on borrowers. As of September 30, 2015, System total capital equaled $48.9 billion, up from $45.8 billion the year before. The System's total capital-to-assets ratio was 16.8 percent as compared with 16.9 percent a year earlier. Moreover, more than 82 percent of total capital is in the form of earned surplus.

The increase in total capital is due in large part to the System's strong earnings performance. For the first nine months of calendar year 2015, the System reported net income of $3.5 billion compared with $3.6 billion for the same period of the previous year. The small decline results from slightly higher non-interest expenses and provisions for loan losses, which offset an increase in net interest income.

Credit quality in the System's loan portfolio continues to be strong. In each calendar year since 2010, the amount of nonperforming loans has declined, and capital has increased. In the most recent period, as of September 30, 2015, nonperforming loans totaled $1.7 billion, or 0.76 percent of gross loans, as compared with $1.8 billion, or 0.85 percent, for the same quarter a year earlier.

The System continues to have reliable access to the debt capital markets. Investor demand for all System debt products has been positive, allowing the System to continue to issue debt on a wide maturity spectrum at very competitive rates. Risk spreads and pricing on System debt securities remained favorable relative to corresponding U.S. Treasuries.

Further strengthening the System's financial condition is the Insurance Fund, which holds just under $4.0 billion. Administered by the Farm Credit System Insurance Corporation, this fund protects investors in Systemwide consolidated debt obligations. System banks also maintain liquidity reserves to ensure they can withstand market disruptions. As of September 30, 2015, the System's liquidity position equaled 183 days, significantly above the 90-day regulatory minimum required for each FSC bank.

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—the 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, unlike System banks, is not jointly and severally liable for Systemwide debt obligations. Moreover, the Farm Credit Insurance Fund does not back Farmer Mac's securities.

Generally Accepted Accounting Procedures net income in FY 2015 was down from the year before primarily due to unrealized gains on derivative positions in the prior year and unrealized losses on derivative positions in FY 2015. These unrealized gains and losses are expected to reverse and converge to zero balances as the derivatives approach maturity. Also contributing to the earnings reduction in FY 2015 were costs associated with the redemption of $250 million of Farmer Mac II LLC Preferred Stock on March 30, 2015. Core earnings, a measure based more on cash flow, were down by 26.0 percent over FY 2015 to $38.0 million primarily due to a large tax benefit in the prior year that resulted from a one-time cash management and liquidity enhancement strategy implemented in FY 2014. As of September 30, 2015, Farmer Mac's core capital totaled $558.2 million, which exceeded its statutory requirement of $442.8 million. The total portfolio of loans, guarantees, and commitments grew 11.6 percent to $15.6 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, 2015, substandard loans were 2.2 percent of total direct credit exposure, compared with 2.4 percent a year earlier. Loans more than 90 days delinquent remained low, although experiencing a slight increase to 0.67 percent from 0.46 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. 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. Our budget proposal identifies our goals and the performance measures we have developed to help ensure that we efficiently and effectively use our resources. It is our intent to stay within the constraints of our FY 2017 budget as presented. We will 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. We are proud of our record and accomplishments. 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.