

**Testimony of the Honorable Dallas P. Tonsager
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
February 12, 2018**

Mr. Chairman and Members of the Subcommittee, I am Dallas P. Tonsager, board chairman and CEO of the Farm Credit Administration (FCA or agency). On behalf of my colleagues on the FCA board, Jeffery S. Hall of Kentucky and Glen R. Smith of Iowa, 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.

Congress established and structured the Farm Credit System (FCS or System) to provide farmers and rural communities access to financial institutions where they have a voice in the decision-making process to ensure the financial needs of rural America are addressed. The System is made up of banks, associations, and service corporations, the Federal Farm Credit Banks Funding Corporation, and the Federal Agricultural Mortgage Corporation (Farmer Mac).

FCA was created to ensure the financial viability of the System and to ensure that the institutions follow their legal obligations under the law. Because the System institutions are uniquely structured, FCA has developed regulatory and oversight approaches that are designed to fit these structures. As a result of the collective efforts of the System and FCA, System institutions each year provide hundreds of billions of dollars in financing to support U.S. agriculture and utilities services in rural America. In carrying out its important mission, FCA does not receive a federal appropriation. Our administrative expenses come from funds that are assessed and collected annually from the government-sponsored enterprises we regulate and examine — the System.

For fiscal year (FY) 2019, we are submitting a proposed total budget request of \$75,280,000. Our proposed budget for FY 2019 includes current and prior-year assessments of \$74,600,000 from System institutions, including Farmer Mac, and \$680,000 from anticipated reimbursable work for the Farm Credit System Insurance Corporation, the U.S. Department of Agriculture, and the National Consumer Cooperative Bank. Of this budget amount, 84.3 percent is for salaries, benefits, and related personnel costs.

A key factor driving the FY 2019 budget is our need to hire and train qualified individuals to replace the many employees — especially examiners — who have begun to retire. Our examiner commissioning program takes five years to complete. Approximately a third of our examination staff is eligible to retire within the five-year planning horizon, and half of the non-examination staff is eligible to retire during the same planning horizon. 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, we continue to dedicate more resources to acquire technology. We anticipate a continued increase in the use of technological and data tools used by agency staff. And we need to invest in cybersecurity and automating manual processes. The funding we have requested for FY 2019 will help us 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 and eligible borrowers in agriculture and rural America. We accomplish our mission in two important ways.

First, we protect the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and ensuring 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, we develop policies and regulations that govern how System institutions conduct their business and interact with customers. Our 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

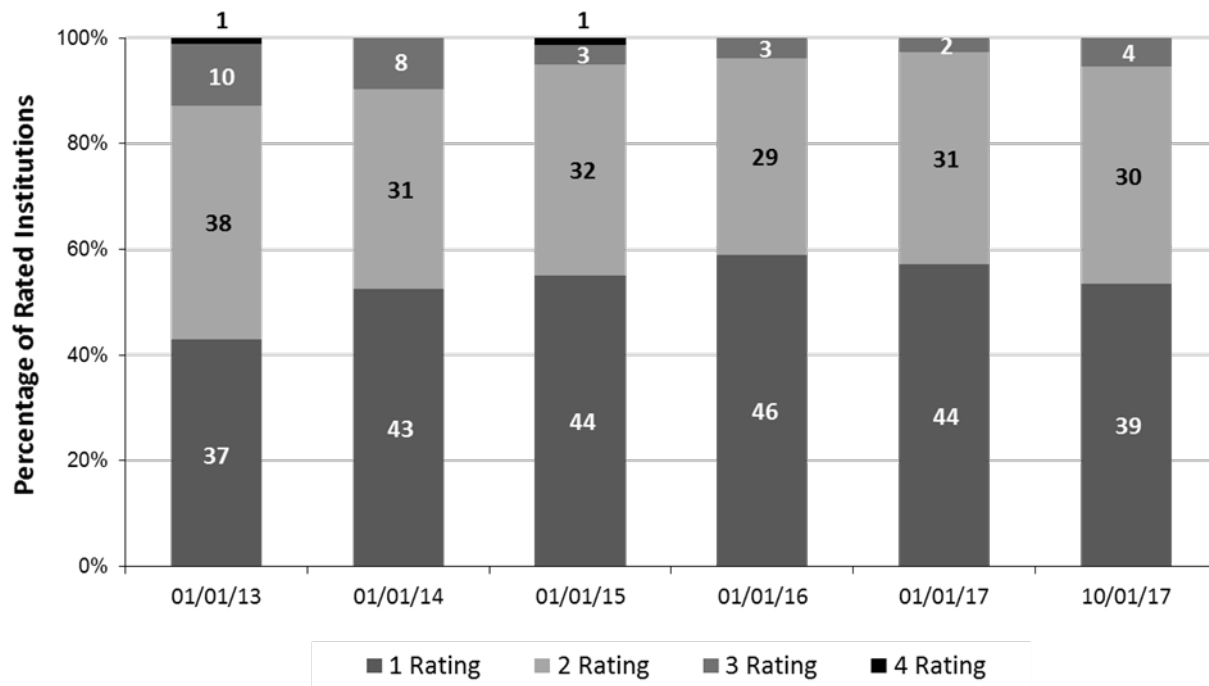
To help ensure the safety and soundness of FCS institutions, FCA uses examination and supervision processes to address material and emerging risks at the institution level and across the System. We base our examination and supervision strategies on institution size, existing and prospective risk exposure, 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 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. Our examination and supervision program promotes accountability in FCS institutions by working to ensure institutions identify and manage risks. Currently, we are closely watching real estate values because lower grain prices and a rise in long-term interest rates are pushing land prices down in certain sections of the country. When necessary, we use our enforcement powers to require institutions to change their policies and practices to correct unsafe or unsound conditions, weak business practices, or violations of law or regulations.

To assess the safety and soundness of each FCS institution, we use our Financial Institution Rating System (FIRS). This system provides a framework of ratings to help examiners evaluate significant financial, asset quality, and management factors. FIRS ratings range from 1 for a very 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. Currently, institutions are well capitalized, and the FCS does not pose material risk to investors in FCS debt, to 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. We have increased supervisory oversight at a number of institutions and dedicated additional resources in particular to the four institutions rated 3. Although these institutions represent less than 1.5 percent of System assets and do not materially affect the System's consolidated performance, they require significantly greater agency resources to oversee. Factors causing the stress include ongoing weakness in specific agricultural sectors as well as institution-specific issues in loan underwriting, risk identification, internal controls, and board oversight and governance. As of September 30, 2017, four FCS institutions were under supervisory actions, but no FCS institutions were under formal enforcement actions, in conservatorship, or in receivership.

Farm Credit System Financial Institution Rating System (FIRS) Composite Ratings



Source: FCA's FIRS Ratings Database.

Note: This chart reflects ratings for only the System's banks and direct-lending associations; it does not include ratings for the System's service corporations, Farmer Mac, or the Federal Farm Credit Banks Funding Corporation. Also, the numbers 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 guidance to ensure that FCS institutions comply with the law and operate in a safe and sound manner. We are committed to developing balanced, flexible, and legally sound regulations. Current regulatory and policy projects outlined in the agency's fall 2017 Regulatory Agenda include the following:

- 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 criteria in the regulations for reinstating nonaccrual loans
- Reviewing stress testing done by System institutions
- Reviewing cybersecurity requirements for System institutions
- Clarifying the disclosure and servicing requirements in the borrower rights regulations
- Evaluating regulations to reduce regulatory burden
- Revising the eligibility criteria for outside directors
- Revising the appraisal regulations for current credit and economic conditions
- Revising the regulations on private flood insurance to conform with the Biggert-Waters Flood Insurance Reform Act of 2012

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 December 31, 2017, the System had 69 direct-lender associations, 4 banks, 5 service corporations, and 2 special-purpose entities.

CONDITION OF THE FCS

The FCS remains fundamentally safe and sound and is well positioned to withstand the current risk environment facing U.S. agriculture. System borrowers will be challenged by strong global competition, rising interest rates, low cash grain prices, declining collateral values, and uncertain agricultural trade policies. 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 in 2018 from relatively strong levels in 2017. Factors supporting the overall condition of the FCS continue to be stable earnings, a strong capital base, and reliable access to debt capital markets.

The System grew at a slower pace in 2017. As of September 30, 2017, gross loans totaled \$251.2 billion, up \$9.0 billion or 3.7 percent from September 30, 2016. Real estate mortgage lending was up \$4.5 billion or 4.0 percent as demand for cropland continued in 2017. Overall, real estate mortgage loans represent almost 47 percent of the System's loan portfolio. Production and intermediate-term lending increased by \$1.6 billion or 3.4 percent from the year before, and agribusiness lending increased by \$1.3 billion or 3.6 percent.

The System also continues to benefit from a strong capital base, which enhances its risk-bearing capacity at a time when System borrowers in certain agricultural sectors face increasing financial stress. As of September 30, 2017, System total capital equaled \$55.5 billion, up from \$52.4 billion a year before. The System's total capital-to-assets ratio was 17.3 percent as compared with 16.7 percent a year earlier. Overall, 78 percent of total capital is in the form of retained earnings.

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 2017, the System reported net income of \$3.7 billion compared with \$3.6 billion for the same period the previous year. Net interest margin remained unchanged at 2.47 percent.

Credit quality in the System's loan portfolio continues to be good. As of September 30, 2017, nonperforming assets totaled \$2.1 billion, or just 0.84 percent of gross loans, which is little changed from a year ago. Relative to total capital, nonperforming assets represented 3.8 percent at quarter-end. For historical comparison, nonperforming assets represented 11.6 percent of capital at year-end 2010.

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

With a balance of just over \$4.7 billion as of the third quarter 2017, the Farm Credit Insurance Fund further strengthens the System's financial condition. 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, 2017, the System's liquidity position equaled 172 days, significantly above the 90-day regulatory minimum required for each FCS 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. As mandated by statute, we have a separate office — the Office of Secondary Market Oversight — through which we regulate, examine, and supervise 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. As measured using generally accepted accounting principles (GAAP), net income available to common stockholders in FY 2017 (ended September 30) was up 49.0 percent from FY 2016 to \$80.1 million.¹ The increase was due primarily to the effects of unrealized fair value changes on financial derivatives and hedge assets in the fourth quarter 2016 which contributed \$17.2 million to net income. Net growth in program business also contributed to increases in net interest income. Overall, Farmer Mac continued to experience less fluctuation in unrealized gains and losses in its derivative positions, and this led to more stable quarterly net income results compared with the prior year. Unrealized gains and losses are generally expected to reverse and converge to zero balances as the derivatives approach maturity.

Core earnings, a non-GAAP measure based more on cash flow, were up by 18.1 percent over FY 2016 to \$62.5 million. Core earnings differ from net income by excluding infrequent or unusual transactions that are not indicative of future operating results leading to a clearer depiction of the financial performance of Farmer Mac. The increase was primarily driven by an increase in net effective spread and a slight decrease in hedging costs. Net effective spread in FY 2017 increased to 92 basis points up from 86 basis points 12 months earlier. Earnings were also up due to growth in program volume as well as continued improvements in LIBOR-based short-term funding costs for floating rate assets indexed to LIBOR. As of September 30, 2017, Farmer Mac's core capital totaled \$653.4 million, which exceeded its statutory requirement of \$515.7 million. The total portfolio of loans, guarantees, and commitments grew 8.1 percent to \$18.6 billion.

Credit quality trends remained favorable, and credit quality in all program business lines remained satisfactory. Credit risk was manageable, and adversely classified volume remained stable. As of September 30, 2017, substandard loans were 3.3 percent of total direct credit exposure, matching the results of a year earlier. Loans more than 90 days delinquent increased to 1.01 percent compared with 0.31 percent in the prior year.

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. We will continue our 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 2019 budget as presented while ensuring we attract and retain the staff needed to accomplish our mission. We will continue our efforts to be good stewards of the resources entrusted to us. We are proud of our record and accomplishments.

¹ All references to time periods and fiscal years refer to the federal government's fiscal year, not Farmer Mac's fiscal year, which corresponds to the calendar year.