Remarks by
The Honorable Michael M. Reyna
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to the
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Good morning. Thank you for inviting me to address the 2001 RAAW Conference. In particular, a special thanks goes to Dave Hogan, Paul Hughes, Becki Wittingham and Rosalie Holen. I'd also like to recognize the FCA staff here with me today, including Roland Smith, Dennis Carpenter and Hal Derrick.

Milwaukee is one of my favorite American cities — what a great place to hold a conference. I trust you have had a chance to experience the sights, sounds and tastes of the town.

I understand that the theme of your conference this year is "Get the Big Picture at the Great Lakes." During my discussion today I will paint a picture of the Farm Credit System and a few of the issues and events on the horizon that will potentially affect "what" you do and "how" you do it as credit reviewers, auditors and appraisers. I will be pleased to answer questions you may have at the end of my comments.

So what is the regulator's view of the Farm Credit System's condition today: The answer in one word: solid. The System today is fundamentally sound in all material respects. Capital levels are up and earnings are good. And, while there are some early signs of deterioration, asset quality remains reasonably good. Furthermore, System liquidity is very good with very favorable debt ratings and debt pricing. Given the current environment, we believe that interest rate risk has been managed reasonably well.

That's the picture today. What, however, will be the picture of the System tomorrow? Our concern rests primarily with the continued stress we see in commodity prices and the general profitability of agriculture going forward. It remains uncertain whether the recent rebound in the futures for some commodities signals a longer-term positive trend.

There are other risks we worry about, and that you probably worry about as well. From ongoing droughts and local pests to exchange rates of the U.S. dollar and its effect on export values to animal health scares and their impact on U.S. domestic and overseas markets; and the impact of rising energy costs to name just a few.

A critical question for every agricultural lender is whether producers will be able to generate positive cash flows to service debt. In the aggregate, government support of agriculture is approaching 50 percent of net farm income. While farmers no doubt appreciate a helping hand from the government during tough times, the farmers I know would rather have their net income come from better prices on the crops they produce.

You and I know that the System was created by Congress to be a dependable source of credit to agriculture during good times and bad. Surely during tough times like these, the healthy capital levels built by your institutions will be needed and tested by increasing risk in the lending environment. We expect, as does Congress, you to work closely and constructively with your borrowers. There are many ways to do this, including increased usage of USDA's guaranteed loan programs. It also means being mindful of borrower rights. I encourage you and your institutions to not lose sight of your important public policy mission.

While you should work constructively with borrowers, you must, however, also do what is right for your institution. This means there is no substitute for solid underwriting standards and lending practices. To fully meet your public policy mandate, your institution must not only serve this generation of farmers, but must also be around to serve future generations of farmers as well. This last point by the way is why FCA pushes the System to put together credible Young, Beginning and Small Farmer programs.

Agricultural lending in these times is difficult. Just ask the commercial banks that are reducing their exposure to agricultural related loans these days. How the System responds to these challenging times is likely to leave a lasting impression on farmers, ranchers and their cooperatives. Will the System be viewed as, and will it actually be, a dependable source of credit?

While this environment and the fact that some commercial banks are pulling out of the market may present new opportunities for the System … institutions need to be particularly careful to not knowingly finance troubled credits that will not survive. Nor should an institution venture into industries where it lacks sufficient expertise to make and service loans adequately.

There are many programs and processes in a financial institution that are important to its success. Speaking as the Chairman and CEO of the Farm Credit Administration, I cannot overstate the importance of the role each of you play in your institutions and in the System. As the System's arms-length regulator, we rely heavily on the work you perform.

Every institution must have an effective program of internal audit and review to identify risks that threaten its safety and soundness. Management and the Board simply cannot function effectively if they do not have accurate and timely information that evaluates and reports on the effectiveness of its system of internal controls and the results of operations.

As you well know, one of the primary focuses of our examinations is to determine the reliability of an institution's internal review and audit program. Failure to maintain an effective program is viewed by FCA as an unsafe and unsound practice requiring prompt corrective action.

I encourage you to be mindful that your role is not to be like a tree that blows in the wind. Nor should your efforts be geared towards going along to get along. You must point out the shortcomings and risks posed by practices or programs that could damage your institution. And, while you may need a little courage to do so, you should do this even when those programs or practices are endorsed by or strongly supported by management and or your Board.

Having encouraged you to be courageous, let me lay out a few matters that I believe should be particularly important to you.

First, be alert to systemic risk that may emerge in your environment and the effects those risks may have on your institution, given its particular financial situation. Be mindful of the risks posed by concentrations to single industries or to a few borrowers, particularly if those borrowers operate in the same industry. Again, be ever vigilant to identify risks to your institutions and discuss those risks thoroughly with management and your Board. They need your help to make informed decisions and chart a proper course of action.

Second, don't become complacent with the routine of your duties. Oftentimes, new risks require a new approach to doing business. Remain alert to emerging risks that perhaps others may not see because they are too close to the actions taken or because they may have even participated in the decisions that led to those actions or programs.

And third, guard your independence as you carry out your role. Keep an open mind and be constructive in your assessments with an eye towards improving and strengthening the organization you serve.

I would like to make a couple of comments with respect to the appraisers who are here today.

The appraisal function of an institution is a well-disciplined program that requires adherence to rigorous rules of industry practice and regulation. By all means, adhere to those rules and regulations in determining the value of the collateral pledged as security on loan assets. However, I also would ask you to consider the collateral risk that may develop to your institution if the income producing potential of the property were to suddenly or unexpectedly dissipate.

I bring this to your attention because I am concerned about the industry concentrations that exist in some institutions. I wonder how much an empty livestock facility may be worth if there was no livestock to make effective use of the facility, or if the specialty enterprise being financed lost its appeal in the marketplace. Management and Board need to be aware of the collateral risk that could emerge if such events were to occur.

While the highest and best use of the property may suggest one value, the reality of a depressed industry may, at a later date, suggest a value somewhat lower. When all things go as expected, such loans usually perform as agreed. However, I urge you to keep in mind that when an industry or the marketplace changes for the worse, the value of specialized property could be materially altered.

I'd like to mention FCA's examination areas for 2002 briefly. These areas include: Business Planning; Portfolio Risk Management; Young, Beginning and Small Farmer Programs; and Electronic Commerce Activities. As I mentioned earlier, Roland Smith is here and can comment on what we will be looking at specifically in the coming year in each of these areas.

I'd like to shift gears now and discuss FCA's upcoming regulatory calendar briefly. I want to skip over the topic of National Charters for just a moment though because we have other important topics on our agenda for consideration as well.

A few of these topics include:

- Removing regulatory restrictions on the System's ability to purchase interests in eligible loans;
- Removing impediments for the System's funding of other financing institutions (OFIs);
- Establishing regulations under which a bank or large association within the System can terminate its charter as provided by the Act;
- Adopting regulations to facilitate electronic commerce within the Farm Credit System; and
- Clarify and provide guidance for implementing the effective interest rate disclosure requirements of the statute.
- There are others as well (capital).

So where are we with the topic of the day: National Charters?

As you know, the agency currently has this proposed regulation under consideration. The primary intent of this regulation is to strengthen the System's safety and soundness by encouraging FCS institutions to diversify their portfolios on a geographic and commodity basis.

A key secondary intent of this regulation is to increase the flow and availability of competitively priced agricultural credit to farmers. Additional effects will include a redoubling of the commitment FCS institutions have to serve their local areas and a strengthening of an institution's business planning activities.

During the last several months, FCA's staff has been evaluating the more than 1,500 comments that have been received regarding this regulation. It has been quite a job and staff deserves much credit for their efforts. About half the comment letters received came from the System itself, with the other half coming mostly from commercial bankers and their trade associations. We also have gotten feedback from the Treasury Department and Congress. I expect the White House to weigh in on the topic as well.

Reaction to the rule has been mixed, with most FCS institutions that commented supporting the rule. Supporters generally cited enhanced safety and soundness and the positive benefits that would accrue to FCS borrowers from competition. Commercial banks and their trade associations generally opposed the rule. Opponents generally cited safety and soundness concerns and the potential for a loss of local control, and negative business consequences from competition.

I anticipate this rule will come before the FCA Board for consideration in October of this year. Regardless of whether the comments on this rule have been positive or negative, one thing is certain. The public debate on this rule has been good. It has helped bring to light issues that were previously obscured and helped to focus our attention — indeed, everyone's attention — on what is in the best interest of agriculture and rural America.

While I can't tell you what the outcome of our October meeting will be, I do believe we have benefited from the debate and the dialogue. Indeed, we should strive to have a vigorous public discussion about public decisions — only when we do this can we claim to serve the public's interest.

If adopted, your role and responsibility will be even more critical as your institution moves into new territory. Your institution's management and Board will need you more than ever. Let there be no doubt that we at FCA are counting on you as well.

Thank you and God bless.

I'd be happy to answer your questions at this time.