Testimony of the Honorable Michael M. Reyna
Chairman and Chief Executive Officer
Farm Credit Administration
Before the
Subcommittee on Agriculture, Rural Development,
Food and Drug Administration, and Related Agencies
Committee on Appropriations, U.S. House of Representatives

Mr. Chairman, Members of the Subcommittee, I am Michael Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). This is my second report to you as the Chairman of the FCA Board. As you know, the FCA Board is a three-member board. Ann Jorgensen, who also serves as the Chair of the Farm Credit System Insurance Corporation (FCSIC), joins me on the Board. The third position on the FCA Board is currently vacant.

I will highlight the FCA's accomplishments during the past year, report to you briefly on the condition of the Farm Credit System (FCS or System), and present our fiscal year (FY) 2002 budget request.

MISSION OF THE FARM CREDIT ADMINISTRATION

The mission of the FCA is to promote a safe and sound, competitive FCS so agriculture and rural America will continue to have a permanent, dependable, and affordable source of credit in both good and bad times. We are not involved in the daily management of System institutions. Instead, our responsibility is to ensure that the System complies with applicable statutes and regulations, and operates in accordance with safe and sound banking practices. We believe that the FCS will continue to play an important role in financing agriculture in the 21st century. We strive to maintain a regulatory environment that enables System institutions to remain financially strong and competitive so they can meet the changing demands of rural America for credit and other services. In doing so, our primary focus is to ensure the long-term safety and soundness of the FCS and develop rules and polices that respect market forces.

FISCAL YEAR 2002 BUDGET REQUEST

We are proud of our accomplishments as the safety and soundness regulator of the FCS and of our ability to contain costs while fulfilling our mission. I assure you that we will continue our commitment to effectiveness and cost-efficiency. We will regularly review how additional progress can be made in meeting these objectives. I am personally committed to a program of continuous improvement.

Before I present the budget request, I respectfully bring to the Committee's attention that the FCA's administrative expenses are paid for by the institutions that we examine. The FCA does not receive a Federal appropriation, but instead is funded through annual assessments of FCS institutions.

For FY 2002, I propose a budget of $38,736,000. While this is an increase of $383,000, or 1 percent, above the $38,353,000 for FY 2001, I can assure you that we are cognizant of our responsibility to be good stewards of the System's resources. Most of this increase is due to adjustments in compensation and benefits for our workforce. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the FCA to keep the salaries of its employees comparable to those of other Federal financial institution regulators.

Our FY 2002 budget request supports a staffing level of 293.6 full-time equivalents (FTEs). By comparison, our FY 2001 budget supported a staffing level of 301.6 FTEs. Although our staffing level has declined by 8 FTEs from the previous fiscal year, I believe we can continue to maintain the right mix of positions and skills necessary to implement our Strategic Plan and accomplish our mission. The proposed budget that we formally submitted to the Committee provides details on the various expense categories and other highlights.

FISCAL YEAR 2000 ACCOMPLISHMENTS

I am proud of our many accomplishments during the past year. In FY 2000, we continued our efforts to achieve the goals of our Strategic Plan through (1) effective risk identification and corrective action, and (2) sensible regulation and public policy.

We have worked hard to maintain the System's safety and soundness at a time when the agricultural economy is experiencing stress. At the same time, we are continually exploring options to reduce regulatory burden on the FCS and ensure it fulfills its public policy mission to provide constructive, competitive, and dependable credit and related services to agriculture and rural America.

Examination Programs

One of our highest priorities is the development and implementation of efficient and effective examination programs that meet the high standards and expectations of the Congress, investors in System debt obligations, the farmers, ranchers, and cooperatives that own System banks and associations, and the public at large. We conduct examinations according to risk-based examination principles, which means we set the scope and frequency of each examination based on the level of risk in the institution. We continuously identify, evaluate, and proactively address these risks. We also use an examination cycle of up to 18 months for certain institutions, where appropriate, as permitted by the Farm Credit System Reform Act of 1996.

We continually enhance our risk identification capabilities. Our Early Warning System identifies existing and prospective risk at FSC institutions. Each institution is reviewed quarterly to identify changes in its risk characteristics, and the Financial Institution Rating System (FIRS) rating is adjusted as needed. In addition, we use our forecasting model semiannually to identify and evaluate prospective risk in FCS institutions over the next 12 to 24 months under "most likely" and "worst case" scenarios, respectively. This includes monitoring trends in prices for various commodities. This proactive approach is intended to evaluate an institution's financial condition and performance under various scenarios to identify institutions with emerging risks and the potential for deterioration. This allows us to implement our differential supervision program to address and correct potential problems. We continue to enhance our modeling capabilities so that we can identify in a timely manner economic developments that may affect the financial condition of FCS institutions.

FIRS uses six components -- Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to interest rate risk (CAMELS) -- to measure the performance of each FCS institution. The FCA assigns every institution a composite rating and a rating for each of the six individual rating components at least quarterly. The FIRS ratings reflect current risk and conditions throughout the System. In addition, our examiners provide continuous oversight of System institutions to ensure that risk in the System is adequately monitored and addressed.

I am especially pleased to report that for the first time in the System's history, more FCS institutions are rated "1", which is the highest FIRS category, than are rated "2". As of February 26, 2001, all rated System institutions, except one small association, achieved a composite rating in the two highest of the five FIRS categories. Currently, no System institution is under an enforcement action.

During FY 2000, other Federal agencies used our expertise. Pursuant to an agreement with the Small Business Administration (SBA), the FCA conducted examinations of Small Business Lending Companies that are licensed to make SBA guaranteed loans. In FY 2000, the FCA helped train examiners in the Office of Thrift Supervision (OTS) who now review an increasing number of agricultural loans made by savings associations. These arrangements help us to maintain the high quality skills of our examiners and defray some of the costs of our operations while providing valuable assistance and service to other Federal agencies.

Strategic Planning and Performance Plans

During FY 2000, we focused on improving our methods for measuring the FCA's performance under the Strategic Plan. We refined the Annual Performance Plan covering FYs 2001 and 2002 in accordance with the Government Performance and Results Act of 1993. The Performance Plan lists our performance measures and goals, many of which link to strategic goals, objectives, and initiatives. These goals and objectives help us to deal effectively with rapid changes in agriculture and the System during both strong and weak economic conditions. We also use these performance measures and goals to assess our ultimate effectiveness in ensuring the safe and sound operation of the FCS.

Regulatory, Policy, and Philosophy Initiatives

Congress has given the FCA Board statutory authority to establish policy and prescribe regulations necessary to ensure that FCS institutions comply with the law and operate in a safe and sound manner. We strive to adopt sound and constructive policies and regulations, using a proactive and preventive approach that reflects the changing needs of agriculture. Our objective is to promulgate regulations that achieve safety and soundness goals while minimizing regulatory burden on System institutions.

During FY 2000, we continued our efforts to remove geographic barriers within the FCS that limit the credit options of eligible farmers and ranchers and prevent System institutions, as single industry lenders, from diversifying concentrations in their loan portfolios. We repealed regulations that required an FCS bank or association to provide notice or obtain consent before it participated in loans that commercial banks and other non-System lenders made in the chartered territories of other System institutions. A Farm Credit bank and five of its affiliated associations opposed the final rule and subsequently filed suit in the United States District Court for the District of Columbia. Their suit asked the court for a declaratory judgment that the final rule is invalid and contrary to law. This action is currently pending.

The FCA is developing a new rule that would remove geographic lending barriers that have restricted the operations of FCS associations for decades. As a result, this rule would enable each direct lender association to apply for and obtain a charter that would authorize it to lend and offer related services to farmers, ranchers, and other eligible customers without geographic restrictions. The rule would require each association to comply with stringent business planning requirements and safety and soundness criteria. Each association must continue to serve, on a priority basis, the credit needs of farmers, ranchers, and other eligible borrowers in its local service area, which in most cases is the area it served before the removal of territorial boundaries. Expanded charters would not include territories of certain associations in four states that the FCA, by law, cannot overcharter unless the shareholders, in some cases the boards, and the funding banks of these associations consent. The FCA has proposed new regulations that would provide a process for the shareholders, boards, and the banks of the affected associations to vote on allowing other FCS associations to serve these areas.

During FY 2000, the FCA adopted final rules concerning regulatory burden on FCS institutions, civil money penalties, standards of conduct, flood insurance, and disclosure to shareholders. Our proposed regulations addressed termination of FCS status, loans to designated parties, FCS funding of commercial banks and other financing institutions, loan purchases and sales, and issuance of stock in service corporations. The FCA Board issued two policy statements. One emphasized the obligation of FCS institutions to protect the privacy of personal information about their borrowers, while the other provided System institutions with more guidance about official and trade names.

Corporate Activities

During the past year, many FCS associations have merged or adopted new corporate structures that include wholly owned operating subsidiaries. These restructurings are expected to lower risk through diversification, reduce operating expenses, and enable associations to use their capital more efficiently while offering their customers a broader array of services on a one-stop basis. The FCA has devoted much time and energy in the past year to processing and approving these corporate applications. In fact, the number of corporate applications received by the FCA set a new record. In FY 2000, we processed and approved 93 applications, which was double the 46 applications that we processed the previous year. We were able to handle the increased workload with our existing staff by reprioritizing other work and using creative and streamlined approaches for processing the applications. We met all 60-day review requirements of the Farm Credit Act of 1971, as amended (Act), unless waived by the applicants, and granted approval before the requested effective date in every case.

CONDITION OF THE FARM CREDIT SYSTEM

I am pleased to report that the FCS is a financially strong and reliable source of affordable credit to agriculture and rural America. The quality of loan assets, risk-bearing capacity, stable earnings, and capital levels collectively reflect a healthy System that has rebuilt its financial strength and improved its management systems. Despite various external factors affecting agriculture, such as reduced export demand, adverse weather conditions, and low commodity prices, the System's strong financial position will help it weather adverse effects from potential deterioration in the agricultural economy.

Since 1994, the System has steadily earned $1 billion or more each year. This has resulted in a large capital cushion that will enable the System to absorb losses and remain a viable lender to agriculture during downturns in the agricultural economy.

The quality of the System's loan portfolio has remained generally favorable despite continued adverse economic conditions in the agricultural sector and a slight deterioration in the performance of certain loans to cooperatives. Signs of deterioration have yet to materialize in the System's loan portfolio, and early warning indicators are much more positive than in the mid-1980s when the System last experienced serious asset quality problems.

Loan volume continues to grow, while the level of nonperforming loans, including nonaccrual loans,[1] consistently remains low. Delinquent loans also remain minimal at less than half of one percent of total loans.

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[1] Nonperforming loans consist of nonaccrual loans, accruing restructured loans, and accruing loans 90 days or more past due.

The System continues to build capital through retained earnings. Total capital as a percentage of total assets has increased from 14.2 percent as of September 30, 1996, to 15.6 percent as of September 30, 2000. All institutions met their regulatory capital requirements, and most greatly exceeded them. Permanent capital ratios at System banks and associations ranged from a low of 9.94 percent to a high of 38.2 percent compared with the 7.0 percent minimum regulatory capital requirement.

Better management practices have resulted in stronger loan underwriting standards at most System institutions. Adherence to strong loan underwriting standards usually results in sound loans. Additionally, this helps insulate an institution's capital from excessive risk in a challenging operating environment. As a result of improving their management and internal controls, System institutions have been diligent in identifying and dealing with troubled loans early on. Also, improved asset/liability management practices have enabled System banks to effectively manage interest rate risk.

Economic stress in agriculture, however, is beginning to temper this good news. Prices for many agricultural commodities are low while farm production costs, particularly for energy, are increasing. As a result, the profit margins of many farmers are squeezed. Federal support for agriculture over the past several years has been necessary to help farmers repay their loans. Obviously, farmers, System institutions, and the FCA would much prefer that more favorable commodity prices would generate higher profits and better income for agriculture. In addition to strong capital and diligent management at System banks and associations, Federal assistance to farmers has also played an important role in helping the System maintain the quality of its loan portfolio.

Two indicators of profitability, net interest margins and net interest spreads, have been trending downward since 1995. Return on assets has also followed a declining trend for the past six years, although it increased in 2000. While these downward trends raise concerns, they also stress why retained earnings and strong capital are crucial to the continued financial strength of System institutions.

The allowance for loan losses continues to be adequate to cover risk in the loan portfolios. Since 1993, the System has steadily increased its allowance for loan losses to almost $2 billion at the end of 2000. This increase is necessary to protect against the stress in the farm economy.

Perhaps the biggest challenge facing the System is the fact that it is a single-industry lender in a shrinking market. The number of farmers and ranchers has steadily declined ever since the System was founded in 1916. However, the System's mission is to finance agriculture in both good and bad economic times. The loan portfolios of System institutions, as single-industry lenders, are concentrated in agricultural commodities. As of September 30, 2000, there were 197 instances at 135 associations where loans to a single commodity exceeded capital. The System lends overwhelmingly to agriculture, which is the sector of the economy that is particularly vulnerable to changes in commodity prices, currency fluctuations, bad weather, diseases, pests, and other difficulties. The FCA will remain ever vigilant with regard to its safety and soundness mission in the face of the challenges confronting the System.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

The FCA has oversight and examination responsibility for the Federal Agricultural Mortgage Corporation, which is commonly known as Farmer Mac. Congress established Farmer Mac in 1988 to operate a secondary market for agricultural mortgage and rural home loans. In this capacity, Farmer Mac creates and guarantees securities that are backed by mortgages on farms and rural homes. We monitor Farmer Mac's operations and financial condition and provide periodic and timely reports to Congress.

On February 21, 2001, we adopted a final risk-based capital regulation for Farmer Mac. The new regulation is designed to ensure that Farmer Mac has sufficient capital to meet its mission, especially during times of economic stress. The final rule establishes a risk-based capital stress test that will determine the minimum level of risk-based regulatory capital necessary for Farmer Mac to maintain positive capital during a 10-year period if stressful credit and interest rate conditions occur. The final rule requires Farmer Mac to run the risk-based capital stress test at least quarterly to determine the adequacy of its capital and to report the results to the FCA. The stress test is based on a statistical model used to project Farmer Mac's capital sufficiency over the 10-year stress period.

The FCA continues to monitor Farmer Mac's debt issuance and non-mortgage investment strategy. We also examine Farmer Mac's strategic and operational business planning. In 2000, Farmer Mac had $10.4 million in net earnings, compared with $6.9 million in 1999 and $5.7 million in 1998. Farmer Mac's capital remains above the minimum prescribed by the Act and its total loan program activity continued to increase, reaching $ 3.19 billion at December 31, 2000.

In conclusion, we are proud of our efforts and accomplishments in ensuring the safety and soundness of the Farm Credit System. We will continue to efficiently manage our resources while performing FCA's mission in the way Congress intended. Mr. Chairman, on behalf of my colleague on the Board, Ann Jorgensen, and myself, I thank you for the opportunity to share this information with you.