**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**
**April 14, 2003**

Mr. Chairman, Members of the Subcommittee, I am Michael M. Reyna, Chairman and Chief Executive Officer (CEO) of the Farm Credit Administration (FCA or agency). On behalf of my colleagues on the FCA Board, and all the dedicated men and women of the Farm Credit Administration, I am pleased and honored to testify before you today.

Speaking of the FCA Board, I'm very pleased to say we now have a full three-member Board for the first time in recent history. Joining me on the board is Doug Flory of Virginia, who also serves as the Chairman of the Farm Credit System Insurance Corporation (FCSIC), and Nancy Pellett of Iowa, our most recent appointment. Together, we are focused on ensuring a dependable source of credit and related services for agriculture and rural America through responsible regulatory efforts and an ongoing program of financial safety and soundness examinations.

One final note before I proceed with my testimony today. I would like to take just a moment to thank the committee staff for their ongoing assistance and professionalism during this entire process.

Now Mr. Chairman and members, 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), as well as the Federal Agricultural Mortgage Corporation (Farmer Mac), the other government sponsored enterprise that we regulate; and, in conclusion, present our fiscal year (FY) 2004 budget request.

**ROLE AND RESPONSIBILITY OF THE FARM CREDIT ADMINISTRATION**

The role and responsibility of the FCA are to ensure a financially safe and sound FCS so that agriculture and rural America will have continuous access to a dependable and affordable source of credit and related services.

The agency accomplishes its mission in two important ways. First, the agency conducts on-site financial safety and soundness examinations of each System institution. Specifically, these examinations focus on a number of areas including an institution's capital, assets, management, earnings, liquidity and sensitivity to risk. These examinations also focus on an institution's efforts to serve all eligible borrowers having a basis for credit, including young, beginning, and small farmers and ranchers.

Secondly, the FCA Board reviews and approves corporate charter changes, and researches and develops and adopts rules, regulations and other guidelines that govern how System institutions conduct their business and interact with their customers. If, in the conduct of its business, a System institution violates a law or regulation, or does not meet safety and soundness standards, we can use our enforcement authorities to ensure the problem is corrected promptly.

The agency strives 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 related services. In doing so, our primary focus is to ensure the long-term safety and soundness of the FCS and develop rules and policies that respect changing market forces.

## FISCAL YEAR 2002 ACCOMPLISHMENTS

I am proud of our many accomplishments during the past year, and I am pleased to report that the FCA received a clean audit opinion for FY 2002 – the ninth consecutive year.

2002 was a busy year for the agency as it continued its efforts to achieve its strategic plan goals through (1) effective risk identification and corrective action, and (2) responsible regulation and public policy.

The agency has worked hard to maintain the System's safety and soundness at a time when the agricultural economy is experiencing stress. At the same time, the agency is continually exploring options to reduce regulatory burden on the FCS and ensure System institutions provide agriculture and rural America continuous access to credit and related services.

### Examination Programs

One of the agency's 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.

As part of our ongoing efforts, the agency continually monitors each institution's risk profile. For example, 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 to the FIRS reviews, we use a semiannual financial forecasting model to identify and evaluate prospective risk in institutions over the upcoming 12 to 24 months under "most likely" and "worst case" scenarios.

By evaluating each institution's financial condition and performance under various scenarios, we can identify institutions with emerging risk and the potential for adverse performance. This evaluation enhances our ability to carry out our risk-based examination program. 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.

On a national level, the agency also actively monitors risks that may affect groups of System institutions or even the entire System. These systemic risks cover the agricultural, financial, and economic environment within which the System institutions operate. Our job is not to forecast specific events, but to understand the environment well enough so that we can take steps in advance to help System institutions should adverse trends develop.

FIRS provides a general framework for collecting and evaluating all significant financial, asset quality, and management factors to assign a composite rating to each institution on a scale of 1 to 5, with 1 being the highest rating. Throughout FY 2002, FIRS ratings as a whole reflected the stable to improving financial conditions of FCS institutions, and the overall trend in FIRS ratings continued to be overwhelmingly positive.

I am especially pleased to note that more FCS institutions are rated “1” than are rated “2” or “3.” In fact, there was only one 3-rated institution at September 30, 2002. In addition, I would note that there were no System institutions under an enforcement action.

During FY 2002, the Small Business Administration (SBA) and the United States Department of Agriculture (USDA) also used FCA’s examination expertise. SBA contracted with FCA to conduct examinations of financial companies licensed by SBA to make guaranteed loans to small businesses. USDA contracted with FCA to conduct examinations of financial companies licensed by USDA to make guaranteed loans under USDA’s Business and Industry Guaranteed Loan program.

I can assure you that the safety and soundness of the System remains our primary objective. However, I also believe the continuing use of FCA examination resources by other agencies is a positive reflection on the expertise of FCA examiners and serves to broaden their examination skills while increasing job satisfaction and employee retention. It also helps us to 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 2002, our work focused on implementing initiatives to accomplish FCA’s strategic goals and on measuring the agency’s performance. We also continued our efforts to comply with the Government Performance and Results Act of 1993 by integrating the budgeting process into the agency’s planning and performance management process. We link performance goals with resource needs, so that we are in a better position to use the strategic plan to align the organization and budget structures with our mission and objectives.

This process provides a tool for setting priorities and allocating resources, which enables us to respond to rapid changes in agriculture and the System during both strong and weak economic conditions. We also use performance measures and goals to assess our ultimate effectiveness in ensuring the safe and sound operation of the FCS.

**Regulatory 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 responsible regulations that achieve safety and soundness and mission related goals while minimizing regulatory burden on System institutions.

During FY 2002, our regulatory and public policy efforts were varied and reflect our commitment to help the System fulfill its congressional mandate. For example, we:

- Held a public meeting and solicited comments from the public to help us decide if our policies and programs regarding Young, Beginning, and Small Farmers and Ranchers should be changed.
- Proposed a rule to amend portions of our capital adequacy regulations regarding certain total liability calculations and limitations of term preferred stock that may count as capital.
- Issued a final rule on electronic commerce to reflect emerging business approaches and remove regulatory barriers, creating a more flexible regulatory environment.
- Issued a final rule to allow an FCS institution to terminate its FCS charter and become a financial institution under another federal or state chartering authority.

- Issued a final rule to enable FCS institutions to better use existing statutory authority for loan participations.
- Adopted a policy statement affirming our commitment to Equal Employment Opportunity and Diversity for members of the public who seek to take part in our programs, activities, and services.
- Issued a bookletter providing guidance to associations and their nominating committees to better identify and select the most qualified candidates for their boards of directors.
- Issued a bookletter concerning the approval under which Agricultural Credit Associations (ACAs) and their subsidiaries operate.
- Withdrew regulations pertaining to national charters; and stockholder votes on like lending authority; and loans to designated parties. The FCA Board took the actions to withdraw these proposed regulations following public debate and comment supporting the action.

## Corporate Activities

The pace of Farm Credit System corporate mergers and restructuring proposals during FY 2002 slowed considerably from that in FY 2001. During the past fiscal year, we processed and approved a total of 24 corporate restructuring proposals from System institutions. This was 45 fewer than reviewed and approved during FY 2001. The decrease in the number of applications reflects the relatively small number of Production Credit Associations (PCAs) and Federal Land Credit Associations (FLCAs) available at the beginning of FY 2002 that could consolidate their operations to form ACAs. As of January 1, 2003, only 13 FLCAs remain as stand-alone associations. By that date, all stand-alone PCAs had merged with ACAs or converted their charters to ACAs.

**CONDITION OF THE FARM CREDIT SYSTEM**

I am pleased to report that the System's overall condition and performance was solid and steady during FY 2002. Capital levels have continued to increase, mostly through retained earnings and stock purchases. Asset quality has remained high, even with high loan growth, and year over year earnings were up once again. By and large, the System has knowledgeable and experienced managers at all levels.

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 Farm Credit System.

Loan volume continued to grow during FY 2002 while loan quality remained high. Gross loans increased almost 10 percent to $87.9 billion. The level of nonperforming loans, including nonaccrual loans,[1] increased slightly but remains low. Delinquencies also remained minimal.

Since 1993, 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.

Total capital as a percentage of total assets has increased from 14.1 percent as of September 30, 1996, to 15.8 percent as of September 30, 2002. All institutions met their regulatory capital requirements, and most greatly exceeded them. Permanent capital ratios at

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

System banks and associations ranged from a low of 10.5 percent to a high of 28.1 percent—all well above the 7.0 percent minimum regulatory capital requirement.

While the overall condition of the System continued to improve during FY 2002 and remained strong, I must also offer a cautionary note regarding several risks we are monitoring. Some commodity prices continue to remain stressed, while interest rates, which have been near 40-year lows, could begin to increase in the coming months. In addition, high and volatile oil prices have increased production costs. Government payments to agricultural producers continue to account for nearly 40 percent of net farm income.

If low commodity prices continue and are combined with cost increases and a significant reduction in government program payments, debt repayment problems - and a resulting upsurge in credit quality problems at System institutions - could result. In addition, the weak general economy may present similar problems for the many farmers with off-farm income.

## 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. Through a separate office required by statute, the agency monitors Farmer Mac's disclosures, financial condition, and operations on an ongoing basis and provides periodic reports to Congress.

Similar to the Farm Credit System itself, Farmer Mac is a government-sponsored enterprise (GSE). As a secondary market-focused entity, Farmer Mac is structured and funded similarly to the housing GSEs, Fannie Mae and Freddie Mac. The FCA and the financial markets recognize Farmer Mac as a separate GSE and apart from the System. Farmer Mac is not subject to any intra-System agreements or the joint and several endorsements of the FCS banks, nor does the Farm Credit System Insurance Fund back Farmer Mac's securities. However, by statute, in extreme circumstances Farmer Mac may issue obligations to the U.S. Treasury Department to cover losses from its guarantees.

Another feature making Farmer Mac unique as an institution examined and regulated by the FCA is that its stock is publicly traded on the New York Stock Exchange. Accordingly, it is subject to certain Securities and Exchange Commission regulatory requirements and must file disclosures that are available to the general public.

The statutory changes authorized by the Farm Credit System Reform Act of 1996 have permitted Farmer Mac to substantially revise its business strategies and operations. Subsequent to the changes granted in the legislation, Farmer Mac has been successful in growing its portfolio at a substantial rate and, thus, also has changed its balance sheet and its risk profile substantially.

Total program-related activity almost doubled to $5.5 billion in the 2-year period that recently ended as of December 2002. Most of the program growth is attributable to the Long-Term Standby Purchase Commitment (LTSPC) program, which was introduced in 1999. The most recent 2-year growth rate of the LTSPC program is over 300 percent, with outstanding principle of $863 million at yearend 2000 growing to $2.7 billion as of December 31, 2002.

In addition to the LTSPC program, which is an off-balance sheet program item, Farmer Mac grew its on-balance sheet program assets from $ 1.7 billion to $ 2.5 billion in the same 2-year period.

In addition to managing program assets, Farmer Mac continues to hold a significant level of non-program investments on its balance sheet, hovering near $1.5 billion in recent years. These assets are held for liquidity, interest rate risk management purposes, and to increase market identity and acceptance of Farmer Mac debt. Accordingly, Farmer Mac policies require them to be high quality investments with minimum exposure of loss.

To further support program growth and to bolster capital levels, Farmer Mac issued 700,000 shares of preferred stock in May 2002, for an aggregate offering price of $35 million.

The FCA Board adopted a final rule in February 2001, which set minimum regulatory risk-based capital standards for Farmer Mac. The rule became effective in May 2002, and Farmer Mac is now routinely submitting quarterly runs of the Risk-Based Capital Stress Test model, which calculates the minimum regulatory capital level. Farmer Mac must meet the higher of minimum core capital amounts set by statue or the risk-based capital rule. As of December 2002, Farmer Mac's capital levels exceeded both the statutory and regulatory minimum levels required. Farmer Mac's recent program growth and its continued maintenance of a significant portfolio of non-program investments make it an important financial institution supporting the liquidity needs of agriculture and rural home loan lenders serving rural America.

In conclusion, the Farm Credit Administration is proud of its efforts and accomplishments in helping to ensure a stable, constructive and dependable source of credit to farmers, ranchers, and their cooperatives. We will remain ever vigilant in our efforts to ensure the Farm Credit System and Farmer Mac remain financially strong and mission focused on agriculture and rural America for generations to come.

**FISCAL YEAR 2004 BUDGET REQUEST**

Before I discuss our budget request, I respectfully bring to the Subcommittee's attention that the FCA's administrative expenses are paid for by the institutions that we examine. Said differently, the FCA does not receive a federal appropriation, but is funded through annual assessments of FCS institutions.

Earlier this fiscal year the agency submitted a proposed budget of $42,029,00 for FY 2004. The proposed budget request is $2,591,000 above our FY 2003 total budget. The agency's proposed budget contemplates an assessment on System institutions for FY 2004 of $38,400,000, an increase of $1,700,000 from the FY 2003 assessment.

I wish to thank the committee for its support during last year's budget process during which several factors necessitated changes to our 2003 budget as proposed. As you may recall, the committee raised the "cap" (limitation on administrative expenses) on our agency budget and assessment to enable the FCA Board to accommodate adjustments to our employee compensation program and to respond to the looming retirement of a number of seasoned financial examiners and other key staff.

Based upon an in-depth study by an independent organization, the FCA Board did adjust salaries to comply with statutory pay requirements for federal banking regulatory agencies (FBRAs). Among other findings and recommendations, the study recommended that FCA's salary ranges be increased 18 percent to be at the average of other FBRAs.

Under the FCA's compensation program, the agency administers a system that effectively attracts, retains, and motivates employees while maintaining comparability with other FBRAs as required by statute. FCA has defined pay comparability as the average market rate paid by other FBRAs, and regularly conducts surveys to ensure comparability.

Regarding the looming "retirement bubble," FCA has taken steps to enhance its recruitment efforts during the past year. A study conducted by PriceWaterhouseCoopers concluded that if FCA is to maintain a viable recruiting strategy, the agency must hire about 10 new examiners in each of the next 5 years. The study underscores the urgency with which FCA must begin recruiting now in order to get new examiners trained sufficiently to replace those eligible for retirement and those that will be lost for other reasons.

While the budget presented to you today is our best estimate of our future needs, it is just that - an estimate. Agriculture and rural America are undergoing rapid change, as is the Farm Credit System. It is these changes, along with the administrative challenges such as recruiting and maintaining a well-trained and motivated workforce, that the Farm Credit Administration is striving to keep up with. We appreciate the committee's past assistance and we need your continued help. Indeed, last year's problem is not a one-time challenge; but rather, an ongoing challenge for the foreseeable future – one for which we need ongoing support from the committee.

As in past years, this year's proposed budget is presented with a limitation, or "cap" on our budget and assessment. Though no other federal banking regulatory agency operates under such a cap, I understand and appreciate the committee's prerogative regarding this matter. As an acknowledgement of the significant changes and challenges facing FCA at this time, however, I respectfully request that the committee raise the budget cap again this year by $2.6 million to create adequate flexibility for the FCA Board to respond to unforeseen circumstances and to address ongoing challenges.

I would note that it is our intent to stay within the constraints of our 2004 budget as presented. Any change to the contrary would be undertaken by a formal public vote by the FCA Board, and only after prior notification and briefing of this committee and staff as to the reasons and rationale for any necessary change.

The agency has worked hard to hold down the assessment to the System for our operations, and I believe we have achieved that objective over the past several years. I think it should be clear to all who review our budget that we have been very good stewards of the resources entrusted to us to accomplish our responsibilities.

In FY 2002, System borrowers paid 3.4 basis points, or about 3.4 cents for every $100 borrowed, which was unchanged from FY 2001. This is the lowest assessment ever, and continues a trend to keep costs to the borrower at the absolute minimal amount. The lower cost is due primarily to on-going FCA cost efficiencies and to increases in the System's total assets.

I would specifically note that in an August 2001 report issued to Senator Richard Lugar, the General Accounting Office stated that FCA's administrative expenses "stayed within the congressionally imposed spending limits for each year during 1997 through 2000." The report went on to point out that, "Overall the agency experienced a decline in administrative spending of around $2 million, or 5.8 percent. As a point of reference, during this same period, the price index for federal government expenditures increased 8.6 percent."

We are proud of our accomplishments as the safety and soundness regulator of the FCS. I assure you that the agency will continue its 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.

On behalf of my colleagues on the FCA Board, thank you for the opportunity to share this information. I would be pleased to answer any questions the committee may have at this time.