Remarks of Douglas L. "Doug" Flory
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I want to thank you for inviting me to participate in your Leadership Institute today. I've now been a member of the Farm Credit Administration Board for just over 15 months, and I've had the opportunity to meet with a number of Farm Credit System institutions during that time. But I especially appreciate this chance to meet with so many leaders from throughout the System. I think this Leadership Institute is a great endeavor and I congratulate you on putting together an outstanding program.

Last August I completed my first year on the FCA Board. It's been a rewarding experience, as well as challenging. And I think I can safely say that it will continue to be challenging and exciting during my entire term on the Board.

Before I discuss my assigned topic, I want to share with you what I have been doing during my first 15 months on the FCA Board, as well as some of the insight I have gained. I have visited about 30 associations, all 5 Farm Credit banks, over 10 System organizations, 5 non-System groups, and all 4 of FCA's field offices. I have visited farms in the Napa Valley, Sacramento Valley and the San Joaquin Valley of California – the Columbia River Basis of Washington State – the High Plains of Texas – the Red River Valley in the Dakotas and Minnesota – and farms in Missouri, the Del Marva Peninsula, Minnesota, Ohio and Indiana.

I came to FCA with some preconceived ideas – those that I developed from being an active farmer – from my commercial banking career – from my Farm Credit experience – and from dealing with rural issues in my home state of Virginia.

I want to share with you some of what I have found during the past year at FCA, traveling the country; attending meetings; visiting with Farm Credit and other rural people from all over America.

1. The System is growing up and out of the problems of the 1980's and early 90's.
2. FCA has matured from the crisis management of the 80's and early 90's to become the regulator of the larger, more complex System entities.
3. Both the System and FCA need to continue to grow and evolve to meet the needs of a changing agriculture and rural America.
4. The System is as different across the U.S. as the agriculture it serves. I am referring here to the philosophy, management, governance and how the System entities serve serve their market places.
5. The FCA staff is extremely knowledgeable, highly experienced, hard working and dedicated to doing what is best for agriculture and rural America, while ensuring a safe and sound Farm Credit System.

6. FCA, like the System, is facing the retirement of the "baby boom generation" and the huge challenge ahead for all of us is to attract, train and retain the staffs we need for the future – not an easy job!
7. The FCA Board is working together on a cooperative and business basis and is committed to setting policy and promulgating regulations, within the parameters of the statute, to allow the System and other lenders to serve agriculture and rural America.
8. The System is losing its political base, especially in Washington. For example, there are few U.S. Senators or Representatives in Congress today who went through the trials and tribulations of the System and FCA during the 1980's. Many members of the Agriculture Committees do not have agricultural backgrounds and do not understand or appreciate the history or role of the Farm Credit System. This has major implications for the System in the future.

The FCA Board and staff are proud of our past accomplishments, and we're confident about our future contributions. Earlier I mentioned that I think the next few years will continue to be challenging and exciting. I share the beliefs of my colleagues, Chairman Mike Reyna and Board Member Nancy Pellet, that the Farm Credit System is at a crossroads. Agriculture and rural America are changing and adapting, and the System must also be willing to change and adapt to compete successfully in the 21st century.

I know many of you wonder how I see the structure of the System changing in the coming years. I've received this question a lot, especially since Chairman Reyna's speech at the Farm Credit Council Annual Meeting in San Francisco last January. He's gotten quite a bit of attention for his comments about a single Farm Credit Bank. Chairman Reyna made clear this was his personal opinion, and the FCA Board has not taken a position and probably will not take a position on this issue.

I think Chairman Reyna makes a strong case for one bank. However, I envision that the evolution of the System will continue during the next several years, and we'll more likely see 3 or 4 Farm Credit Banks having different philosophies during that transition period. During this evolution, I also envision associations having more freedom to align with those banks sharing their philosophy. I would hope that the System addresses this situation soon because I think it is important that associations have more flexibility to align with a bank that best fits their needs and philosophy.

Since joining the FCA Board, I have also received many questions on what I think about National Charters or Regulation 4070, which relates to chartered territories. My standard response is that this is no longer an issue for the FCA Board – it is an issue for the System. I really believe that the System, especially with the reduced number of institutions today, is in a position to handle the territorial concurrence issue by itself.

I point to the outstanding cooperation shown by the former Wichita District associations in reaching an agreement on territorial concurrence. That sets a good example for the rest of the System -- and the System should learn from that example.

At the same time, I realize that there are some sensitive and difficult problems to overcome due to the special territorial situation with Louisiana, Mississippi, and Alabama. But this is a cooperative System, and I am confident that by working hard in a cooperative, business and constructive way, while keeping the best interests of borrowers in mind, you will find ways to continue to serve the market in these three states.

A topic that is very important to me is governance. Since becoming a member of the Farm Credit Administration Board last August, I've had the chance to visit with a number of Farm Credit institution boards. In each visit, governance was at the top of my list of issues to discuss with them.

One of my greatest concerns is how the evolution and complexity of the System is resulting in more and greater demands on its directors. These demands require that they be more knowledgeable about the business of directing their System institutions, because the business is getting more difficult to understand with more complex products.

Also, I firmly believe that with continued consolidation within the System, and with association and bank managers becoming more market driven, the challenge of board governance will be even greater in the future. Therefore, I think it is essential that Farm Credit institutions have effective leaders and policy makers to direct the System's future development and success.

It is very important that board members have the right combination of knowledge and skill sets to do the best job they can in serving the System institution. This is becoming even more important as the size and complexity of associations and banks increase. I believe this makes it especially important that new board members have good business and financial skills.

In the past, I think there was a tendency to believe that board members did not need good business and financial skills, and that they could pick up what they needed after coming on the board. That is no longer the case. The growing size and complexity of today's associations and banks, combined with the aggressive market driven managers, can quickly overwhelm a director who does not possess the background and skills needed to understand the operation and the potential impacts of their decisions on the institution.

We recently approved the Fall 2003 Unified Agenda of Federal Regulatory and Deregulatory Actions. I'm glad that we included a new item on the regulatory agenda dealing with governance. Although we already have a very full regulatory agenda, I think it is essential that we address the governance issue.

I also point out that, as a result of the recent corporate scandals in America, Congress passed the Sarbanes-Oxley Act, which greatly increases accountability and transparency in corporations. I have heard some comments that Sarbanes-Oxley does not apply to Farm Credit institutions because they are cooperatives. While I acknowledge Sarbanes-Oxley may not directly apply to the System, particularly the reporting requirements to the SEC, I believe the intent of that legislation is good business principles – transparency, fairness, and accountability -- and those principles apply to all U.S. businesses no matter what their structure – corporation or cooperative. It is simply a prerequisite for the integrity and credibility of business and financial institutions.

Directly related to the governance issue is the importance of the board audit committee. To do the best job it can, a board of directors needs to have a good audit committee. A good audit committee, and especially its chairman, should be independent, thoroughly understand the financial and accounting procedures, know the IT systems, understand the ethics and compliance programs, monitor internal controls, be able to oversee the work of the outside auditors, and provide an <u>independent</u> review.

One of my goals – and I believe my FCA Board colleagues share my goal -- is that the agency adopt a regulation requiring Farm Credit associations to have audit committees. Currently, the regulations only require audit committees for Farm Credit Banks. But now, especially with the consolidation in the System and more complexity, I believe association boards also need audit committees. The agency will address this, as well as reviewing audit committee standards, as part of the governance regulation project.

I know some in the System may view this as adding unnecessary regulatory burden. But if the System ever finds itself again facing a seriously deteriorating financial condition, and we are called up before the Agriculture Committees, I can assure you that I would not want to be in a position of having to answer to Congress on why the safety and soundness regulator did not require audit committees for all System institutions.

This leads me to another point I would also like to briefly address -- the outside director selection process. This also relates to what I said earlier about my concerns with the evolution and complexity of the System and the greater demands on directors.

Here again, I think it is important to seek independent outside directors with strong financial backgrounds and experience. I also strongly encourage having more than one outside director. This would help the institution strengthen and diversify its directorate and add special areas of expertise and independence, which may not be present among existing members.

Going a step further, for good governance, I believe it is essential that boards evaluate their skill sets, including personality traits and their overall board performance. While as a government official, I can’t endorse a specific product or service, I do know the Farm Credit Council has in place a program for board evaluation and training – as do some other organizations. As I meet with bank and association boards, I encourage them to use these educational programs to bring governance to a higher level.

As I have been meeting with System institutions around the country, another one of my key discussion issues is diversity. Diversity includes demographics, both geographic and commodity representation. But in addition, striving for diversity should include considering different experiences, skill sets, and viewpoints.

Diversity also includes considering women and minorities, not just for boards, but also for nominating committees, management and employees. There is a need for good, open dialogue in the System on how to improve diversity. I believe Farm Credit Boards should keep this issue in mind as they seek independent outside directors. I would also encourage them to address diversity as a part of their strategic planning efforts.

There have already been questions from some members of Congress asking about the extent of diversity in the Farm Credit System – both at the board and staff level. Also, you have probably noticed that Congress itself is becoming more diverse with many more women and minority members. I think it is only a matter of time before one or more members of Congress seriously question the degree of diversity in the System, particularly in the context of its GSE status.

As I spent time on the Hill seeking support for my nomination, the most frequent question I heard was, "When will the System's governance, management, and staff look more like America?" Farm Credit boards need to be proactive on the diversity issue.

Earlier I mentioned how agriculture and rural America are changing. Last February I attended the USDA Agricultural Outlook Forum. The theme of that conference was "Competing in the 21st Century." One of the speakers, USDA Deputy Under Secretary Rodney J. Brown, noted that, "Today, the nonfarm economy anchors much of agriculture. Most small family farms are dependent on diversified rural economies that offer off-farm income opportunities." He noted that nearly 90 percent of total farm household income in 1999 originated from off-farm sources.

Brown makes the point that "rural" is not synonymous with agriculture anymore. Farming no longer anchors most rural communities and economies as it did through the mid-20th century. Today, 7 out of 8 rural counties are dominated by manufacturing, services, and other nonfarming activities.

Despite these changes, rural and farm communities are becoming increasingly interdependent. Job growth in agricultural areas is now more likely to come from rural industries related to farming than from farming itself. The health of the rural economy and the effective operation of rural labor markets are of crucial importance to the continued economic well-being of both farm and rural households.

I think this supports my belief that the rural marketplace is changing from having a focus on agriculture to having a focus on rural America. I also believe this means that for the Farm Credit System to successfully compete in the 21st century, it must be able to facilitate and enhance this shift in focus to rural America.

At the USDA Outlook conference, Agriculture Secretary Ann Veneman said, "Competing in the 21st century means above all that we must be prepared to address the challenges and take advantage of the opportunities in the ever-changing marketplace." I agree with Secretary Veneman and believe her statement especially applies to the Farm Credit System. To successfully compete in the 21st century, the System must be prepared to address the challenges of the ever-changing marketplace in rural America.

I think these trends showing a changing agriculture and rural America are important because I am concerned about the future of the Farm Credit System as a Government-sponsored enterprise, and also for FCA as its regulator. There has been a lot of attention recently about GSEs by the news media and others -- much of it criticism -- and whether there is a future need for GSEs. I recognize most of the criticism has been primarily directed at the housing GSEs. However, with the continuing consolidation in agriculture, and fewer and fewer farmers and ranchers, I think the System's GSE status may more likely be called into question.

As I said earlier, to meet the changing needs of agriculture and rural America, I think the System must also be willing to change and adapt. The System can accomplish some of these needed changes on its own, and I will talk about this some more a little later. However, some other needed changes may be beyond the System's ability to accomplish by itself.

For our part, I believe FCA should do what it can, within the confines of the law and safety and soundness principles, to facilitate the System's ability to serve a changing rural America. I personally would like to see the agency adopt a more flexible regulatory philosophy, which I believe would help the System adapt to the changing credit needs of agriculture, as well as to the changing structure of the industry.

I think this would also be consistent with the trends of other financial regulatory agencies. For example, recent studies indicate that other regulators have adopted a more flexible, facilitating view of the regulatory function that encourages change that is consistent with the broad public purpose of the industry. The FCA Board recently addressed these philosophical issues during our strategic planning efforts. I'd like to emphasize the "vision" contained in our strategic plan – "The Farm Credit Administration is dedicated to maintaining a flexible regulatory environment while ensuring safety and soundness." Our draft strategic plan is currently posted on the FCA Web site for public review and comment until November 20, and I invite you to read it and provide any comments you might have.

I want to emphasize that while I favor a more flexible regulatory approach, I also recognize that FCA has a broad public policy role and must consider many varying viewpoints and opinions. We must be open to input provided by both the System and the broader general public as we tackle regulatory issues. For example, this past summer we issued an Advanced Notice of Public Rulemaking and held a public hearing to gather input on the issue of eligibility and scope of lending by Farm Credit institutions. The scope and eligibility comment period just ended on October 29, and staff is now reviewing the comments received.

We also issued an ANPR and held a public hearing last year in Kansas City on loan programs for Young, Beginning and Small Farmers. After much review and analysis of the comments received, the FCA Board recently approved a proposed YBS regulation. The comment period is scheduled to close on November 14, but we have received a request for a 60-day extension. The FCA Board will consider that request at our meeting next week. In any event, I also encourage you to review that proposed rule and submit your input to us.

And, as I pointed out earlier, we have a very aggressive regulatory agenda, and I'm sure it will generate a wide variety of comments and opinions, making for many difficult decisions in the future.

But even if FCA were to adopt a more flexible regulatory environment, there still may be some other needed changes requiring legislation for the System to fully serve a changing rural America. I agree with Chairman Reyna's statement at the Farm Credit Council Annual Meeting that the Farm Credit Act is out of date. The 1971 Act has not kept pace with the changes in agriculture and rural America, and I believe the '71 Act will need to be updated before the System can fully serve the rural marketplace of the 21st century.

As I mentioned, there are some changes I think the System can and should do on its own. I believe System institutions need to do more in building partnerships and alliances – both within the System and with other agricultural lenders. I think more emphasis in the future will be on partnering with others. I see a need for more willingness by associations to work with each other and also form alliances with other organizations, especially commercial banks. There is too much of a "we versus them" attitude on both sides, and this needs to change. Working to build more alliances and partnerships will only improve service to agriculture and rural America.

I'm pleased to note that at our FCA Board meeting last July, we adopted a proposed regulation to improve cooperation between Farm Credit System and non-System lenders. We will be accepting comments on this proposal until December 22nd. As with the YBS issue, I invite you to submit comments on the OFI proposed rule. You can access these proposals on our Web site at www.fca.gov.

To preserve and enhance the System as a GSE, my vision for the future includes the oldest GSE in America growing to a level that it continues to be not only relevant, but vital, in financing the ever-changing needs of rural America. The System and FCA, in my opinion, are the only institutions financing and regulating agriculture that really understand the biological industry.

Achieving these objectives will not be easy, but in my mind will be necessary. It will require much deliberation, building coalitions and forming alliances, compromises and agreements on how to best serve agriculture and rural America. Only then can Congress be approached about changing the Farm Credit Act of 1971. And the message to Congress must **not** be about expanding or modernizing the authorities of the Farm Credit System, although that will be needed. Rather, in any major legislative effort to change the Act, the message to Congress must focus on enhancing rural America and its future development.

I want to pause here and say that I am currently committed to doing everything possible, within the current statute, to help you meet the needs of today's financing opportunities. Bi-modal agriculture – large production units vs. life style farming have financial needs today that are distinctly different, and our regulations need to address them in the best possible way, again within the confines of the law.

I believe that the transitioning in and out of agriculture today is very difficult to address within the regulations. As I mentioned earlier, I also believe strongly that FCA must be flexible in its regulatory approach in order to serve a changing rural America, but while ensuring safety and soundness. I believe my colleagues on the FCA Board share my views on this issue.

As the Farm Credit System moves into the 21st century and continues to evolve in serving a changing rural America, I think it needs to take special care to remember its "cooperative roots." Democratic control, which is an integral part of the cooperative nature of the Farm Credit System, had its roots in the 1916 legislation that started the System. Subsequent Farm Credit legislation over the decades has reaffirmed the cooperative nature of the System.

Congress created a very effective mixed rural credit system, with Farm Credit institutions owned cooperatively and commercial banks owned by investor shareholders. The cooperative nature of the Farm Credit System has been one of the keys to its success for nearly 90 years. Not only has the cooperative structure served the System well from a business standpoint, it has helped generate much of the support and defense of the System throughout its history in serving the credit needs of farmers, ranchers, cooperatives and rural America.

With this historical perspective in mind, I believe the cooperative principles of the System will likely continue to be key to its future success – both in its business operations and its pursuit of legislative changes.

Let me now briefly highlight some of the current issues that we are dealing with at FCA, and that may be of interest to you. I've already covered the Governance, YBS, Scope and Eligibility, and OFI issues, so I don't think I need to say any more about those topics.

- <u>Syndications and Participations</u> – This is another difficult and complex issue. The FCA Board recognizes the importance of funding to agriculture and rural America through multi-lender transactions, including loan syndications and participations. Earlier this year, FCA published a notice seeking public comment on the regulatory treatment of System loan syndication transactions. Staff is now reviewing the comments and will bring a recommendation to the FCA Board on how we should proceed on this issue.
- <u>Joint & Several Liability</u> – With the continuing consolidation of the System, the issue of joint & several liability is becoming a very important issue. Less than 40 percent of the System's capital is at the bank level, and declining. We have this issue on our regulatory agenda, and an FCA staff workgroup is now beginning their review of it. The FCA workgroup is coordinating with a System workgroup on this important issue.
- <u>FCSIC Premiums</u> – Because of the substantial growth by the System, the Farm Credit System Insurance Corporation Board in September 2002 raised the premium rate on all accrual loans from 3 basis points to 12 basis points. This was needed for the Insurance Fund to make progress towards attaining the 2 percent of Secure Base Amount. We also chose not to use the Board's discretion to lower the premium rate on GSE guaranteed loans. At the most recent FCSIC Board meeting this past September, we lowered the premium rate from 12 to 10 basis points, but again chose not to lower the rate on GSE guaranteed loans. We will do a mid-year review of the premium rates and the GSE guarantee issue again next March.

In conclusion, there are many challenges ahead for the Farm Credit System, but there are also many opportunities. I encourage the System to embrace these challenges by working together and with others in better serving agriculture and rural America.

I want to thank you again for inviting me to your Leadership Institute, and I’m looking forward to working with you during my term on the FCA Board.