

**Remarks and Testimony
of the
Honorable Michael M. Reyna
Chairman and Chief Executive Officer
Farm Credit Administration**

October 3, 2000

Good morning. Chairman Leach, Congressman LaFalce, and members of the House Committee on Banking and Financial Services, I am Michael M. Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). Thank you for the opportunity to address your committee regarding structural changes occurring within the Farm Credit System (FCS or System).

With your consent Mr. Chairman, I would like to make a brief opening statement and then respond to questions from you and the Committee.

The Farm Credit System is a nationwide network of about 150 direct lending institutions that are cooperatively owned by the farmers and ranchers that borrow from them, and the seven banks that fund those institutions. One of the seven banks also provides financing needs of cooperatives that serve agriculture. System institutions generally operate within chartered territories established by the Farm Credit Administration. Collectively, the System has total assets of about \$89 billion.

Today the System has about \$72 billion in loans outstanding to farmers, ranchers, aquatic producers, agricultural cooperatives, and rural homeowners. As of June 30, 2000, there were over 425,000 stockholders in FCS institutions. The System's average loan size on June 30 for long- and short-term loans, not including cooperative loans, was about \$83,000.

The Farm Credit Act states that the System was created as a permanent system of credit for agriculture to provide for an adequate and flexible flow of money into rural areas for the purpose of improving the income and well being of American farmers and ranchers. A key objective of the Act is to modernize and improve the authorizations and means for furnishing such credit. By law, System institutions must be responsive to all types of agricultural producers having a basis for credit by providing equitable and competitive interest rates. System institutions also have a special congressional mandate to develop and implement programs targeted at young, beginning, and small farmers. FCA is charged with the responsibility for implementing the Farm Credit Act.

As an independent agency in the Executive Branch, the FCA regulates and examines FCS institutions. The Agency is governed by a bipartisan, three-member Board. Members are nominated by the President and confirmed by the Senate to six-year terms. Our mission, as directed by Congress, is to ensure a safe and sound and competitive Farm Credit System.

For much of the past decade, while overseeing the System's return to financial health following the agricultural credit crisis of the 1980s, we have taken numerous actions to strengthen the safety and soundness of the System. By doing this, the System is better prepared to meet the challenges of rapid changes in agriculture and the financial marketplace.

During this time, the Agency held extensive discussions and briefings with leading economists, academicians, public policy experts, and System representatives and other stakeholders. A major safety and soundness concern central to the discussions was that the System is a single sector lender. Furthermore, many FCS associations have in their loan portfolios concentrations because of their narrow geographic territories.

Concentration and geographic risks are not new issues for the System. The Secretary of the Treasury in May of 1990¹ issued a report on Government-Sponsored Enterprises that stated the System faces unusual business risk for several reasons. One reason is that it is limited to a single business sector that is characterized by high volatility. Another reason is that FCS charters limit individual institutions to providing credit in specific geographic regions. Therefore, an institution's "performance can rise and fall with the fortunes of a single crop or perhaps with those of a limited number of customers."

Following our extensive discussions and debates, the Agency ultimately concluded that rigid territorial constraints posed unsafe and unsound conditions on System institutions which hinder their capacity to serve agriculture and rural America if we do not act wisely, it will continue to do so in the coming decades. Therefore, in July 1998, the FCA Board issued a philosophy statement that, among other things, announced support for removing regulatory geographic barriers imposed on System institutions.

Our first major step in implementing the FCA Board's philosophy statement occurred in November 1998, when the FCA published a proposed rule that would have eliminated "notice and consent" requirements in our existing regulations. These regulations restrict lending activity outside a direct lender's chartered territory. This is done by requiring a direct lender in one territory to give notice and consent from another direct lender before financing a borrower in the other institution's chartered territory.

The Agency received over 200 letters and considerable comments during the 180-day public comment period. Reactions were roughly split. The Board suspended action early this year to allow further study. In April 2000, a final rule was published that deleted requirements for a System institution to provide notice to or seek consent from other System institutions when

¹ Report of the Secretary of the Treasury on Government Sponsored Enterprises, May 1990, page D-15.

it buys certain participation interests in loans originated outside its chartered territory. By repealing these provisions, the FCA Board authorized System institutions to enter into loan participations with non-System lenders, including community and commercial banks, anywhere in the United States.

The FCA Board did not remove the “notice and consent” requirements for direct lending. Instead on March 8, the Board announced plans to remove geographic barriers by granting national charters to FCS direct lender associations that apply for them. Later, through an Informational Memorandum dated May 3, 2000, sent to all FCS institutions, the FCA Board provided guidance on national charters by publishing a Booklet entitled *National Charters*. The Booklet also was published on our Website May 3.

The Booklet imposes no requirements on System institutions. FCS institutions must voluntarily apply for any charter amendment. The Booklet communicates the FCA Board’s willingness to accept national charter applications from direct lenders. Because the Booklet has no binding effect, our General Counsel determined that the Booklet is not subject to a notice and comment requirement.

However, we also responded to your concerns, Mr. Chairman, as well as the concerns of others by publishing the Booklet in the *Federal Register* in July 2000. As an additional opportunity to allow input from all interested parties as the FCA Board considers its future chartering decisions. We received just over 1,000 comments. The FCA staff is in the process of analyzing and evaluating these comments. The Board will seriously consider and weigh carefully all substantive comments received regarding national charters.

With this information as background, Mr. Chairman, I would like to address the six questions you requested I cover in my testimony today.

1. In general, what unique public interest purpose would be served by granting national charters to a myriad of FCS entities?

The over-riding public policy purpose of FCA's National Charter Initiative is to further the safety and soundness of the Farm Credit System by updating and modernizing the System's credit delivery structure. Put simply, this effort would end FCA's practice of generally issuing exclusive territorial charters to System direct lenders. The Farm Credit Act governs the eligibility of borrowers. This effort does not modify or otherwise expand rules or regulations governing that eligibility. Instead, it allows for the extension of the territory where the authorities can be exercised. Again, this effort does not modify or otherwise expand rules or regulations governing borrower eligibility.

The System is overwhelmingly a single-sector lender to an industry that is particularly volatile due to prices, weather, disease, pests, and other factors. While nothing in this Initiative would change that, it would enable System institutions to better manage these risks by diversifying their operations geographically and by reducing portfolio concentrations of certain commodities.

To remain a viable source of credit for America's producers and rural communities, as directed by Congress, the System must be able to respond to the changing environment in which it operates. The credit and capital markets are changing rapidly in response to globalization, new technologies, and financial modernization legislation. The System must also change.

FCA's statutory authority to grant and amend the charters is clear and unambiguous. And, this authority has been reaffirmed in court. With limited exceptions, statutes do not provide for exclusive charters for System institutions. Rather, exclusive charters for direct lenders have been a general practice and policy of the agency. Notwithstanding this fact, there currently are a

number of System institution territories that are over-chartered and have been for some time. None of these areas has posed any safety and soundness concerns.

For much of the last decade, the FCA Board has publicly discussed and debated modernization of the Farm Credit System, including specifically whether to end the policy of exclusive charters for direct lenders. The Board has sought public comment and input from a wide variety of sources including the general public, academicians and policy experts. The inherent risk resulting from exclusive charters is known and well documented. The Secretary of the Treasury, and others, acknowledge the concentration and geographic risk in the System and its limited structure. Therefore, the issue and the debate are not new.

It was based upon this debate and discussion, that the FCA Board first considered, and later suspended, action on its efforts to remove “notice and consent” requirements in our existing regulations. Because of FCA’s regulatory numbering scheme, this effort was commonly referred to as “4070.” The practical effect of these regulations is to restrict lending activity outside a direct lender’s chartered territory. This is done by requiring a direct lender in one territory to give notice and receive consent from another direct lender before financing a borrower in the chartered territory of the other System institution.

Following a general suspension of its efforts to repeal 4070 earlier this year, the FCA Board did approve the repeal of certain “notice and consent” provisions relating to loan participations. By repealing these provisions, the Board authorized System institutions to enter into loan participations with non-System lenders, including community and commercial banks, anywhere in the United States. This action is consistent with the Board’s general efforts to help institutions improve the geographic and commodity concentration situation and which will help strengthen their safety and soundness.

2. Are there market niches for these FCS entities not competitively served by other GSEs and financial services companies?

Rather than a unique market niche, the System has a unique mission -- it is expressly designed to serve farmers, and ranchers, and their cooperatives across America. Since 1916, the FCS has ensured that credit is available to eligible producers and rural residents in good times, and more importantly, at times of economic stress, when other credit sources have withdrawn or are just not available. The System is an active partner with farmers and ranchers, helping to build a strong economic base for agriculture.

Although agricultural credit needs may appear to be well served by the FCS and other lenders, other lenders do not have a specific mission to serve the agricultural sector during an economic downturn, and can abandon farmers to seek profit opportunities elsewhere.

National charters will improve the System's ability to carry out its mission of providing a permanent supply of credit to agriculture and rural America. The guidelines for national charters clearly outline the Board's expectations that a System institution must first serve agriculture within a Local Service Area.

3. Please describe the cost-benefit and needs analysis the FCA used in demonstrating the need for national charters.

Much thought, discussion, and study are behind the proposal to allow national charters within the System. Our public discussion on ending the policy of geographically restrictive charters in the Farm Credit System dates back to 1994, when the FCA asked for public comments on a proposed FCA Board policy statement on non-exclusive charters. See 59 FR 17543 (Apr. 13, 1994).

While no formal cost-benefit study was conducted, the FCA Board consulted various experts about how the System could best respond to trends in agriculture and the financial markets. These briefings, discussions, and information exchanges enabled the FCA Board members to hear firsthand what the System needed to do to position itself to continue to serve the needs of agriculture and rural America, both now and in the future. The consistent message we heard was that choosing to maintain the status quo in the System would ultimately hinder its ability to serve a changing agricultural environment in a safe and sound manner.

4. What safety and soundness risks are raised by expanded lending authority for FCS institutions and how will the FCA manage those risks?

National charters are intended to enhance the safety and soundness of the Farm Credit System. Removing existing boundaries will allow System associations to reduce their credit risks by diversifying the geographic and commodity mixes in their loan portfolios. As long as System institutions follow sound lending practices, there are no new or unique risks because national charters do not permit them to expand outside of their agriculture expertise.

Numerous regulations require institutions to follow safe and sound lending practices, regardless of where the loan originates. Additionally, our capital regulations automatically limit an association's ability to grow its loan portfolio uncontrollably, just like other regulated financial institutions. The FCA also conducts both ongoing monitoring and onsite examinations of System institutions, and FCA has full enforcement authorities to correct deficiencies if an association does not implement timely, effective corrective action.

5. What assurances can the FCA provide that the national charter initiative will not translate into increased GSE-related risks for the American taxpayer?

For the record, there is no explicit government guarantee for the FCS. American taxpayers are protected by an independent regulator, FCA, with comparable regulatory and enforcement powers that have been granted to other financial and banking regulators. FCA has a proven track record as an effective financial regulator. The necessary regulations, capital requirements, enforcement tools, oversight strategies, and most importantly, the professional staff, are in place to ensure the FCS remains safe, with minimal risk to the public and at no cost to the taxpayers. Additionally, the System has returned to financial health. New policies, management skills, improved controls, and surveillance systems are in place that were not present in the 1980s. Capital and earnings are also strong with annual earnings exceeding \$1 billion for nearly a decade. Through the Contractual Interbank Performance Agreement (CIPA) and the Market Access Agreement (MAA), System leaders monitor all institutions' asset quality, capital, earnings, and asset-liability management practices. Through the CIPA internal ratings system and the MAA, access to funding and the security markets is controlled and penalties are enforced through a series of required actions by a Farm Credit bank if risks become excessive.

Finally, Congress established a special insurance fund to protect against loss from the FCS. The Farm Credit System Insurance Fund has reached its "secure base amount" with over \$1.4 billion of funds. In the event of a crisis, all these measures provide insulation from any possible risk to taxpayers.

6. How will the FCA ensure that FCS institutions do not become captive of large agribusiness interests and that they fully meet their statutory obligations to serve the small family farmer?

FCA regulations require that each institution operate under cooperative principles, which will ensure that FCS institutions will not become captive of any particular entity. By regulation, FCS association stockholders vote on the basis of one person, one vote. While the broad FCS mission is to serve all creditworthy farmers and ranchers, it also has a special obligation to serve certain interests, including young, beginning, and small farmers and ranchers (YBS). The National Charter Booklet emphasizes that each System institution must continue to do its part in meeting the System's public-policy mission as defined in the Act, including service to YBS farmers and ranchers.

In conclusion, Mr. Chairman, the FCA Board believes that national charters can mitigate safety and soundness risk by improving geographic diversity and reducing concentration risk in a System institution's loan portfolio. System institutions that hold national charters will be more diverse and financially stronger than if we continue to limit them to restricted territories. Finally, national charters will also help ensure the System remains a dependable source of credit and competitive in the rapidly changing financial services industry. I want to reiterate that the Board will seriously consider and weigh all substantive comments before taking action on any pending national charter application.

Mr. Chairman, by moving to bring down rigid territorial boundaries and thereby reduce geographic and commodity concentrations, the FCA Board is encouraging System direct lenders to adhere to the age old adage that it is unwise to place all of your eggs in one basket.

Again, thank you for this opportunity to more fully explain the FCA Board's intentions regarding the National Charter initiative. I would be pleased to answer any questions at this time.