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
March 24, 2004

Mr. Chairman, Members of the Subcommittee, I am Michael M. Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or agency). On behalf of my colleagues on the FCA Board, Doug Flory of Virginia and Nancy Pellett of Iowa, and all the dedicated men and women of the Farm Credit Administration, I am pleased and honored to provide this testimony to the Subcommittee.

At the FCA we are focused on ensuring a safe, sound and dependable source of credit and related services for agriculture and rural America as we maintain a flexible regulatory environment that meets current and future rural credit needs while ensuring safety and soundness.

Before proceeding with my testimony today, I would like to take a moment to thank the committee staff for their ongoing assistance and professionalism during this entire process.

Before I discuss the role and responsibility of the Farm Credit Administration and 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 regulate and examine. Said differently, FCA does not receive a federal appropriation, but is funded through annual assessments of Farm Credit System (System) institutions. We fully support the proposed 2005 Budget Submission of the President.

Now, Mr. Chairman and members of the Subcommittee, I will highlight the FCA's accomplishments during the past year; report to you briefly on the System, as well as the Federal Agricultural Mortgage Corporation (Farmer Mac), the other Government-Sponsored Enterprise (GSE) devoted to American agriculture that we regulate; and, in conclusion, present our fiscal year (FY) 2005 budget request.

MISSION OF THE FARM CREDIT ADMINISTRATION

FCA's mission is to ensure a dependable source of credit for agriculture and rural America.

The agency accomplishes its mission in two important ways. First, the agency conducts safety and soundness examinations in each System institution. Specifically, these examinations focus on a number of areas including an institution's capital, assets, management, earnings, liquidity and sensitivity to interest rate 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 approves corporate charter changes, and researches, develops, and adopts rules, regulations and other guidelines that govern how System institutions conduct their business and interact with their customers. If a System institution violates a law or regulation, or is operating in an unsafe or unsound manner, 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 2003 ACCOMPLISHMENTS

2003 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 buffeted by an array of challenges and stresses. 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 System institutions, while some are examined annually.

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 semi-annual 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, respectively.

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 fashion, 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, including risks that may arise from the agricultural, financial, and economic environment in 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 factors to assign a composite rating to each institution on a scale of 1 to 5, with 1 being the highest rating. Throughout FY 2003, FIRS ratings as a whole continued to reflect the stable asset quality and management conditions of FCS institutions, and the overall trend in FIRS ratings continued to be overwhelmingly positive.

I am especially pleased to note that there were nearly three times as many 1-rated FCS institutions as 2-rated institutions. Furthermore, there were no 3-, 4-, or 5-rated institutions as of September 30, 2003. In addition, I would note that there were no System institutions under enforcement actions.

During FY 2003, 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 (B&I) Guaranteed Loan program. Also, FCA examiners completed reviews of B&I program operations at selected USDA state offices.

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.

Looking forward to FCA examinations during 2004, we will focus on several key areas: First, continued monitoring of System progress in meeting the needs of creditworthy young, beginning, and small (YBS) borrowers, while maintaining safety and soundness and compliance with all laws and regulations. Second, our examinations will focus on whether each System institution has an effective system of internal controls in place.

Internal controls serve as checks and balances against undesired actions and provide a reasonable assurance that institutions will operate in a safe and sound manner. In particular, our examiners will consider a number of factors when assessing an institution's internal controls, including:

- Management philosophy and operating style;
- Organizational structure;
- Methods of assigning authority and responsibility;
- Personnel policies and practices;
- Performance accountability;
- External influences; and
- Audit and review programs.

Strategic Planning and Performance Plans

During FY 2003, 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, goals, and objectives.

The FCA Board was engaged in a full range of issues during the past year, but none more important than the creation of the agency's Strategic Plan for fiscal years 2004 through 2009 (Plan) that will guide the agency efforts over the next five years. This Plan – which was unanimously adopted by the FCA Board – was developed through a consensus building process and reflects a wide array of input from farmers, ranchers, System representatives, academics, economists and finance specialists, the Farm Credit Council, the American Bankers Association, the Independent Community Bankers of America, as well as former FCA Chairmen, senior managers and employees. Specifically, the Plan provides for continued focus on ensuring the System's safety and soundness and mission fulfillment, but also adds an internal focus on implementation of the President's Management Agenda.

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 the regulatory burden on System institutions.

Consistent with this guiding regulatory philosophy, the agency continued its efforts during FY 2003 to work on a wide range of regulatory issues with input from the System and the broader public. Our first and foremost effort was to solicit comments and suggestions for regulatory burden relief and other regulatory exception requests.

Beyond these issues, however, our regulatory focus has been on:

- Strengthening governance, conflict of interest, compensation disclosure, and audit committee standards;
- Developing appropriate risk weighting for mortgage-backed securities and asset-backed securities consistent with other federal bank regulatory agencies;
- Exploring capital adequacy issues regarding the net collateral ratio requirement for System banks and a capital leverage ratio requirement for other System institutions;
- Examining credit and related services to address regulatory burden comments and to incorporate statutory changes provided by the 2002 farm bill;
- Removing unnecessary impediments for the System funding of other financing institutions (OFIs), including the risk weighting of OFI loans made by System banks and borrower rights applicable to loans made by OFIs;
- Enhancing our oversight efforts regarding the System's mission to serve YBS farmers and ranchers;
- Reviewing and approving the System's updated market access agreement;
- Studying the appropriate treatment of loan syndications; and
- Exploring issues surrounding the System's scope and eligibility of lending.

The agency's regulatory agenda for 2004 is no less ambitious. The agency anticipates pursuing a number of other issues, including:

- Considering whether authorized "related services" should include farm management and agricultural trust related services;
- Modifying investments eligibility criteria, portfolio limits and liquidity requirements;
- Redesigning the agency's Loan Accounting and Reports System and making revisions to our call reports;
- Reviewing the priority of claims in relation to the statutory joint and several liability requirements imposed on the System;
- Clarifying existing regulations regarding effective interest rate disclosures;
- Redoing existing regulations regarding distressed loan restructuring; and
- Continuing to explore various issues regarding capital adequacy.

Moreover, relative to Farmer Mac, the agency will be undertaking regulatory projects related to non-program investments and liquidity, as well as revising our risk-based capital standards and requirements.

Corporate Activities

The pace of System association restructuring slowed considerably during the past year, though bank-level activity actually increased. Specifically, the number of corporate applications submitted for FCA Board review and approval during FY 2003 declined to eight applications, compared with 24 applications the prior year. As of January 1, 2004, there were 110 Farm Credit System institutions, including 97 associations, 5 banks, and 8 service corporations and special purpose entities.

Other Activities and Accomplishments

I would like to note a few other agency activities and accomplishments:

First, an audit of FCA's 2003 financial statements has been completed and I am pleased to announce that – for the tenth year in a row – we have received an unqualified audit opinion.

Second, like many other organizations in the post-9/11 world, our agency has taken proactive steps to ensure the continuity of our operations in the event of a disaster. For example, we have upgraded our computer recovery capability by establishing an emergency operations center "warm site" that allows us to restore essential computer services within a few hours. We have also joined the Financial and Banking Information Infrastructure Committee (FBIIC). This is an information sharing and coordination group with respect to issues relating to homeland security pertaining to federal financial agencies, other FBIIC members, and financial sector participants. FBIIC is tasked with ensuring that critical financial infrastructure is identified and protected.

Third, we are building on the e-government initiatives that are currently in place. Not only do we have a Web site that is easy to navigate and has been designed to ensure handicapped accessibility, but over the past 2 years we have:

- Provided the System the ability to enter call report data over the Internet;
- Made our call reports and other reports available over the Internet; and
- Made public data from the call reports available over the Web.

Currently, we are working on a way for the public to comment on FCA's proposed regulations and to read the comments of others via the Internet. This functionality will first be provided on our Web site and then later we will partner with the Environmental Protection Agency (EPA) to provide the ability to comment on proposed regulations and read comments of others on a government-wide Web site sponsored by EPA.

Fourth, we continue our ongoing efforts to be good stewards of our budget. For

2003, System assessments to cover agency operations amounted to only 2.9 basis points, which is the lowest level in over a decade relative to total System assets. We note the following facts:

- The growth rate of our budget and assessment has been far below that of the federal government's rate of growth since 1995.
- If our agency was assessing System institutions at the same rate we were assessing them in 1995 (5.1 basis points), they would be paying almost double what they actually pay today.
- FCA's recently approved budget for 2004 is below what the agency "actually" expended in 1995.

Fifth, the agency revised its employee performance evaluation system completely and, when combined with the previously updated agency compensation program, moved towards a true pay-for-performance system. The value added outcome of this effort is a results-oriented agency workforce that is evaluated and rewarded fairly.

Finally, the agency is continuing its implementation of a value-based management system to guide our daily efforts in very practical and commonsense ways. This approach is grounded in the belief that each and every employee is a valuable member of our team and that "what" we do is as important is "how" we do it.

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 2003. Capital levels continued to increase, mostly through retained earnings and stock sales. Asset quality remained high, loan volume grew moderately and though it remains near last year's all-time high, the System's $1.3 billion in net income for the nine months ended September 30, 2003, was $31 million lower than for the same period the previous year. 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 2003 while loan quality remained high. Gross loans increased by 3.9 percent to $91.3 billion. The level of nonperforming loans, including non-accrual loans, was essentially unchanged at approximately 1.4 percent of gross loans. Delinquencies also remained minimal.

Since 1993, the System has steadily earned $1 billion or more each year. This has resulted in a capital cushion that should enable the System to absorb losses and remain a viable and dependable lender to agriculture and rural America during downturns in the agricultural economy.

Total capital as a percentage of total assets remained at nearly 15.8 percent as of September 30, 2003. All institutions exceeded their minimum regulatory capital requirements. Permanent capital ratios at System banks and associations ranged from a low of 10.0 percent to a high of 28.8 percent – all well above the 7.0 percent minimum regulatory capital requirement.

While the overall condition of the System continued to improve during FY 2003 and remains strong, I also must offer a cautionary note regarding several risks that we are monitoring that could adversely affect borrower repayment capacity in the future:

- Animal health issues in both the cattle and poultry industries have led to significant disruptions in export markets and will likely lead to increased production costs. While impacts on prices have been manageable so far, further health concerns could cause significant changes in consumption patterns and result in lower prices to producers.

- Government payments to agricultural producers have accounted for nearly 40 percent of net farm income in recent years, although higher commodity prices are expected to lower this percentage substantially for 2004. The mounting budget deficit, forecast to reach nearly half a trillion dollars in 2004, combined with international pressure to lower farm subsidies, could lead to reduced government support for the agricultural sector in the future.

- High and volatile energy prices have increased production costs for farmers and farm processors.

- Interest rates, which have remained near 50-year lows are expected to increase by the end of 2004, thus increasing interest costs for producers since most farm loans are made on a variable-rate basis.

- Farm families are heavily dependent on off-farm employment for total family income. Sluggish employment growth in the off-farm economy could present financial problems for the many farmers and ranchers that have become dependent on off-farm income for the majority of their household income.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

The FCA also 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.

Like the Farm Credit System, Farmer Mac is a Government-Sponsored Enterprise (GSE) devoted to agriculture and rural America. 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 from the System's banks and associations. Farmer Mac is not subject to any intra-System agreements to the joint and several liability 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 fulfill the obligations of its guarantees.

Another unique feature of Farmer Mac 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 its shareholders and the general public.

The statutory changes authorized by the Farm Credit System Reform Act of 1996 created a renewed opportunity for Farm Mac. Subsequent to the changes granted in that legislation Farmer Mac has grown rapidly and, in the process, has changed its risk profile.

By statutory design secondary market GSEs, including Farmer Mac, operate at lower capital ratios than primary market lenders. Accordingly, regulating and monitoring Farmer Mac's capital and risk management are central components of FCA's oversight activities.

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

FISCAL YEAR 2005 BUDGET REQUEST

Earlier this fiscal year the agency submitted a proposed total budget of $44,003,000 for FY 2005. The proposed budget request is $1,665,000 above our FY 2004 total budget. The agency's proposed budget contemplates an assessment on System institutions for FY 2005 of $39,400,000, an increase of $1,000,000 from the FY 2004 assessment. Since approximately 83% of the agency's budget goes for salaries, wages and related costs, almost all of this amount will be used for this purpose.

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 such changes, along with administrative challenges, such as recruiting and maintaining 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.

I would note that it is our intent to stay within the constraints of our 2005 budget as presented. 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. By way of comparison, Mr. Chairman, I would urge the Committee to look back 15 years to the conditions that existed in the System and the challenges faced by FCA at that time. 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 in order to meet our responsibilities. The FCS has regained its financial health and is poised to serve rural America for years to come.

We are proud of our record and accomplishments. I assure you that the agency will continue its commitment to excellence, 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.