I appreciate the invitation to attend. Mr. Childs has asked me for the past three years, and I am glad I was able to attend this year. I just didn’t know until last Friday that I would be speaking. So I thought I would cover some general topics that I hope hit some of the subjects you are interested in hearing and then leave time for questions.

**Current board structure**

As you are well aware, our friend and my colleague, Ken Spearman, passed away a year ago last month. I miss him. His leadership and legacy will be evident in our agency and the Farm Credit System for many years to come. Last December, Glen Smith from Atlantic, Iowa, was sworn in as a board member for the Farm Credit Administration. It is easy to see that his background and experience are going to be very valuable to FCA.

**Current ag economy/System**

The current financial conditions of the agricultural economy are obviously one of the key issues that we are all following very closely. Just last week the board was updated on economic conditions affecting the Farm Credit System. The System continues to grow at a modest pace, with $330 billion in assets and $260 billion in total gross loans. System earnings and total System capital continue to increase. Loan quality remains favorable, with nonperforming loans at 0.76 percent of gross loans. And loans classified as less than acceptable remain at relatively low levels.

Obviously, where the System stands today is a result of a very good stretch of farm profitability in the middle part of this decade. Also, producers paid down much of their debt, and interest rates remain historically low. In addition, the System as a whole made some changes in preparation for the inevitable decline in farm income. Those things and some others lead us to believe the System is well positioned to work through the current commodity price declines.

For several reasons, we are highly unlikely to see a repeat of the 1980s, but I have to say that I have a bit of an uneasy feeling about the ag economy. Part of it is I am a product of the 1970s and 1980s, and what in hindsight looks obvious today was not so apparent then. Whether it is weather, interest rates, land values, trade, the farm bill, or the general economy, there are a number of clouds gathering on the horizon. It’s just unsettling to wait for the clouds to either scatter and disappear or build into a storm.
Data/information
One of the initiatives at FCA is to look for ways to better utilize the data we already have available. The System has data on agriculture lending that is the most comprehensive and up-to-date data set on the financial conditions in agriculture. In my opinion, it is currently underutilized, and we are working to identify or create tools that do a better job measuring the financial conditions of the System and the System’s borrowers. I believe there are analytic tools that will help us both to look forward and to review trends.

Although we live in an age of abundant data, we sometimes lack useful information. Data is a valuable tool, but data can’t tell the whole story and should not cloud common sense. Data gives us insight into transactions, success, and financial stress. Interpreting data, however, still relies on knowing the practices and procedures of the institution, the lender, and even the borrower.

Internal controls over financial reporting
While progress has been made, the System continues to work on strengthening internal controls over financial reporting (ICFR), and this needs to remain a top priority for all institutions. Transparency and consistency in financial disclosures are critical to investor confidence, market access, and System credibility and reputation.

We need to work together to enhance due diligence and internal controls. I am glad that the ICFR Workgroup continues to provide communication, education, and training. I am hopeful that these efforts will make for a smooth transition now that the General Financing Agreements have been updated effective January 1, 2018.

Ken Spearman, an accountant by profession, made internal controls a priority of the agency. He believed, as I do, that a strong and effective system of internal controls is important to the regulator, but may be even more beneficial to banks and associations to maintain the confidence of the investment community that purchases Farm Credit System debt.

I recognize there is concern over cost of compliance. As a director, I encourage you to look at internal controls as a benefit, not a barrier. The system of internal controls is the first line of defense, an early warning system that you, as directors of your institutions, need to trust.

FCSIC topics
Let me shift topics some and talk about the Insurance Corporation. We ended last year with a significant surplus in the Insurance Fund, $175.8 million. We were able to repay the total outstanding Financial Assistance Corporation stock of $13.1 million and refund $162.7 million to the banks while maintaining the 2 percent secure base amount. (The adjusted Insurance Fund balance was $4.8 billion at the end of 2017.) In January of 2018, the FCSIC board set premium rates at 9 basis points for 2018 based on an estimate of a 6 percent growth of outstanding insured obligations.

FCSIC contracted with Oliver Wyman to study whether the statutorily mandated 2 percent secure base amount is the appropriate benchmark or whether there is a more actuarially sound target for the Insurance Fund. We continue to believe the 2 percent level recommended in the statute is the appropriate level to hold in the Insurance Fund. Beyond
the study, we are considering a more sophisticated way to predict insurable debt. As FCSIC chairman, I am particularly interested in reducing the volatility in the year-over-year insurance assessment.

**Principles-based approach to standards of conduct rule**

FCA has been reviewing the current standards of conduct rule with the goal of establishing broad but well-defined core principles for behavior that directors and employees of System institutions are expected to follow in carrying out their official duties.

The effort is to set clear expectations for the board of directors to establish a standards of conduct program with internal controls to test compliance and hold individuals accountable and to clearly outline prohibited conduct. FCA will then examine for compliance.

**Farmer Mac**

Earlier this year at the Farm Credit Council annual meeting, there was some discussion about the capitalization of Farmer Mac. Let me say that Farmer Mac and the FCS banks and associations have very different business models. Not only do we view it as appropriate to consider the differences in the business models of primary lenders and a secondary market provider, but the Farm Credit Act requires FCA to recognize the reduced risk in appropriately structured secondary market transactions.

Farmer Mac's book of business consists of large proportions of low-risk assets (more than 50 percent) – including USDA-guaranteed securities and AgVantage bonds. True, the financial crisis of 2008 exposed serious concentration issues with Farmer Mac’s liquidity investment portfolio. But, like the System, its program business volume remained strong.

On a risk-weighted basis, Farmer Mac reported a 13 percent tier 1 capital ratio at year-end 2017, which is within an acceptable operating range on a risk-adjusted basis. FCA’s comprehensive oversight program of Farmer Mac is conducted independently through the Office of Secondary Market Oversight (OSMO).

By regulation we conduct an annual assessment of Farmer Mac’s capital plan and capital adequacy under various stressful scenarios. OSMO also has access to well-qualified examiners through OE to help support the examination and oversight of Farmer Mac’s capital adequacy.

**System capitalization**

Let’s talk about System capitalization. That is a topic getting considerable attention currently, specifically on what might be the appropriate level of capitalization. The System is a bit unique because banks and associations are each required to hold a prescribed level of capital through the leverage ratio. Plus, the CAMELS scores determine the level of capital required to attain certain FIRS benchmarks.

Some very interesting work has been done at the loan level for six (now nine) of the larger associations. It has provided deeper insight into how different levels of capital requirements are stacked within the reviewed associations and their funding banks. It also provides some comparisons with other federally regulated financial institutions. So the appropriate level of capital required is in the eyes of the beholder and, in my mind, can be boiled down to a few key points. Here they are, in no particular order.
• Requiring too much capital to be held by institutions does limit the System’s ability to meet increasing credit needs.

• Requiring too little capital to be held does pose a risk to the safety and soundness of the System since capital is the cushion in case the value of the bank’s assets declines or its liabilities rise. It is the most important tool in covering any losses.

• Since the System is considered a monoline lender, are there greater inherent risks to consider? Conversely, do monoline lenders have greater expertise and better underwriting standards?

• Because there is major variation in the size of institutions within the System, are there reasons to treat capital requirements differently for each institution?

• Given the current strong financial condition of the System, will changes in capital requirement really put the System in a stronger financial position?

• Would a change in capital requirement increase the risk associated with the Insurance Fund? How would the rating agencies view the change?

• Is this the right time for significant changes, given the increasing credit risks caused by the softer ag economy?

We are one year into implementing the new capital rules; our Office of Examination developed criteria to assess capital adequacy under the new rules. This included certain numeric benchmarks that our examiners could use when evaluating what capital rating an institution should be assigned. Now that the new capital regime has been in place for over a year, FCA staff is reviewing whether any changes are warranted in how we examine and evaluate capital adequacy at System institutions.

As you know, capital is only one of six components we use to evaluate the safety and soundness of System institutions under FIRS. Today, we want to make this clear: achieving a FIRS 1 capital rating is not — in itself — the only measure of strength for a System institution.

There are some institutions who have decided to maintain a FIRS 1 capital rating and have made it sort of a self-imposed minimum. That is their decision and not an FCA expectation. If an institution is following prudent risk management practices, it can safely operate with a FIRS 2 capital component rating.

I will tell you that I remain open minded. We need to keep the conversation moving forward and be willing to listen to all opinions in this important discussion. The loan information that has been aggregated and analyzed has provided valuable insight into the efficiency and effectiveness of the System’s largest institutions.

**System structure**

The Farm Credit System’s century-long success is due in large part to its cooperative structure. Members of the cooperative feel a sense of ownership, and directors have a responsibility for the success of the association.
The reputation of the System relies on fundamentally sound decisions in every board room. The System isn’t a combination of 73 separate sovereign institutions but rather a group of very interdependent, interconnected cooperatives bound by a statutory mission.

The System is dependent on a few advantages that Congress granted it. Do not take for granted the System’s GSE status or its tax status. Critics of the System will be spending political capital to, in their mind, “level the playing field.” There are sound policy reasons behind the System’s GSE status. I have heard GSE status described as the “crown jewel” of the System. Mergers and consolidation are clearly a way to gain efficiency of operations, but to what end? There is a tipping point and I don’t know where that is, but it will be argued that a larger, consolidated, and concentrated Farm Credit System no longer needs or deserves GSE status.

Since the beginning of 2017, FCA has approved two large mergers. The agency decided to require attestation of its stress testing by an independent third party. This new condition was imposed for several reasons, not the least of which was the size and the concentration risk of the resulting institution.

Stress testing, even outside the context of mergers, is something I hope the System will embrace so that the agency does not have to move beyond its current guidance.

I don’t have any particular agenda on System structure, but I do have a concern about the rate of consolidation and mergers. There can be any number of good and valid reasons to consider mergers when you look at them on a case-by-case basis; what I think needs to be a part of the discussion is the broader consequences to the System as a whole.

- Diminished representation of cooperative membership on institution boards
- Diluted direct personal contact with elected representatives
- Concentration risk of institution management
- Reputation risk

I wish I had answers, but I really believe those decisions are best left in the hands of the members of the institutions themselves. As long as any merger meets the threshold of fully informing the owners before any vote to merge and the institution has completed a thorough analysis and due diligence and submitted sufficient documentation to FCA, then it should be left in the hands of those who are members. That is the cooperative way.

Thanks for what you do. For those of you who are association directors, it is an awesome responsibility. Directors are the stewards of the Farm Credit System, which was intentionally created as a cooperative.

You were elected to help lead your institution, and whether it is large or small, it has an impact on the entire System. In very real ways, your decisions will impact not only the member-borrowers who elected you but your institution and the whole System. The System is only as strong as its leadership. The reputation of the System relies on fundamentally sound decisions in every board room.

As a member of a board of directors, you hold the fiduciary responsibility of your institution and must exercise reasonable care in governing your institution’s activities. Together, you
and your fellow board members are responsible for the safe and sound operation of your institution regardless of economic condition. Your decisions reflect not only on your association and your funding bank, but the System as a whole.

**Conclusion**

In the three years since I joined the FCA board, I have gained a greater understanding of the Farm Credit System and the importance of a strong and reasonable regulator. The Farm Credit System has an extremely important and valuable mission. While we may not always agree, we must be willing to listen to each other.

We each have our own unique roles in ensuring that farmers and ranchers have a dependable source of constructive credit and related services in good times and bad. I feel fortunate to be a member of the FCA board and I truly respect and appreciate what the Farm Credit System does to serve our nation’s farmers, ranchers, agribusinesses, and rural communities.

Thanks for the opportunity to be with you today.