Remarks by
The Honorable Kenneth A. Spearman
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AgFirst Farm Credit Bank
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Good morning. Thank you for inviting me to speak with you today.

I am happy to report that, since I met with you last June in Hot Springs, Virginia, the System continues to be safe and sound. For the first six months of 2015, it had solid earnings and higher capital levels. Loan quality in the System's portfolio also continues to be very good.

The drought hasn't relented in California yet, but climatologists are hopeful that it may ease soon. Of course, as we saw just a month ago, opposite extremes can be devastating too. The historic storm that hit the Carolinas in October was an event that occurs just once in a thousand years. Producers, especially in South Carolina, were hit hard. This may create credit quality stress in some of your district's loans. The good news is that you are well-positioned to handle the stress. Both capital levels and credit quality in the AgFirst District remain strong, so I am certain your institutions can work through this issue.

But as a regulator, I would be remiss not to tell you about some clouds on the horizon that are likely to have a more prolonged and widespread effect on the Farm Credit System. USDA projects net farm income to drop by 36 percent in 2015. This decline will no doubt put stress on some System borrowers. You will need to manage your portfolios carefully and proactively to guard against the additional credit risks.

There's also another way you can prepare yourself for stressful times, and that is to ensure that you have strong internal controls in place. Since becoming Chairman of the Farm Credit Administration last year, I have emphasized the importance of internal controls. Earlier this year, we issued Informational Memorandums on the subject, and I promote internal controls in every speech I deliver to System audiences.

Internal controls are important at any time but especially when times get hard. Mistakes that are inconveniences in good times can be crippling in stressful times. With a strong set of internal controls, you have a much better chance of weathering economic downturns and credit stresses.

As a former public accountant, I understand the value of internal controls. That's why one of my highest priorities as chairman of FCA is to promote strong internal controls in System institutions.

In their examinations of System banks and associations, our examiners are looking closely at internal controls this year. But what does this mean? What exactly are they looking for in their internal control reviews? Several things.

First, they'll review the written policies, and they'll ask a range of questions about them:
- Are they up to date?
- Are they clearly written?

- Do they take into account the specific risks currently facing the institution?
- Are there any gaps?

But they'll also look at the implementation of the policies:
- Are all employees aware of them?
- What procedures have been created to implement the policies?
- How does the institution report back to its management and board regarding policy implementation?

By asking questions like these, our examiners can help you identify any weaknesses you may have in your internal controls. I hope you will find the feedback you receive from our examiners helpful. Their job is not to "pull a gotcha" but to help you identify potential problems and to provide valuable direction for correcting these problems.

Having said this, I should add that the most effective tool in helping you identify and correct weaknesses in internal controls is the self-assessment. You know better than anyone else where your weaknesses may lie and how to address them. So I encourage you to work with your audit committees to review your internal controls and make sure they are working effectively.

Having strong internal controls can help protect your institution from threats to its public reputation, its safety and soundness, and — ultimately — to its ability to fulfill its congressional mission.

As I mentioned when I spoke with you in June, we may eventually develop a proposed rule to strengthen internal controls, but don't wait until then to take action. You can get out ahead of problems by acting now to shore up any weaknesses you may have in your controls.
Another safeguard to protect financial institutions in troubled times is to maintain strong liquidity and capital levels. As the System's regulator, we are working hard to ensure you have the regulatory framework you need to withstand economic downturns and slumps in the financial markets.

In 2013, we updated our regulations to strengthen the liquidity reserve held by the System's four funding banks. And last year, we adopted the proposed capital regulation. The proposed rule incorporates many of the elements of the Basel III Accord while taking into account the cooperative business model under which the System operates. My goal is to adopt a final capital rule during my chairmanship of the FCA Board. The revised rule would make the System's capital structure more comparable to other financial institutions. This, in turn, could provide a benefit in the issuance of System debt.

At FCA, we're big believers in getting out ahead of problems before they become unmanageable. That's why, for a recent strategic planning session, we asked our economists to put together a set of assumptions regarding the condition of agriculture and the financial markets over the next few years. I'd like to share with you now some of these assumptions.
At the top of the list was the assumption that grain and oilseed prices will continue to be lower than they were between 2010 and 2012. That may last for a few years. In fact, some of these producers may not be able to cover their production costs.

To protect against credit risk exposure, you will need to manage your loan portfolios carefully to guard against over-concentration in agricultural sectors under stress.

Also on this list is the assumption that interest rates will rise over the long term. Now, I realize that economists have been warning us about this for so long that they're beginning to sound like the boy who cried wolf. But eventually, and probably soon, the rates will indeed rise. And this rise in interest rates will make any declines in farm income even more of a challenge.

Another assumption our economists hold is that the value of the dollar will remain high compared with the value of the currencies of our trading partners. This is a positive thing for American tourists abroad but not so much for American farmers whose products are heavily exported.

In fact, at our Board meeting in October, one of our economists presented a report on the risks and rewards of exporting farm products to China. Our exports to China are likely to decline not only because of the strong dollar but also because of the slowdown in the Chinese economy. You will need to take into consideration the credit risks presented by farmers who rely heavily on exporting their products, especially if those products go to China.

Another assumption involves farmland values. As expected, we're now seeing a correction in farmland values in the Midwest. With weaker farm incomes and slowly rising interest rates, farmland prices there could decline 25 to 30 percent over the next several years. Annual changes in farmland prices outside the Midwest will depend on local economic conditions, such as interest rates and commodity prices. You will need to watch those closely to guard against collateral risk.

Our economists also project that the rural economy will struggle over the next few years — both because of lower farm incomes and the continued migration of rural residents to urban areas. This will put pressure on the tax base of rural government and the customer base of rural utilities. It may also increase stress on farmers who rely on nonfarm income to pay off their loans.

That's why the agency has continued to allow institutions to invest in rural community projects on a case-by-case basis. We recognize that, by investing in a meat processing facility, a hospital, or a nursing home in rural America, you are helping the communities in which farmers live to become more viable. You are helping them withstand these downturns in the farm economy.

So far, all of the assumptions I've mentioned are challenges. But I'm happy to report that our economists also found some opportunities. Consumer demand for locally produced, organic, and value-added agricultural products continues to grow. As a result, local food systems, organic farming, and urban agriculture will also continue to grow. I recently saw an excellent example of this when I toured a small, organic, urban operation in Austin, Texas.

The operation had started out as a garden in a family's backyard and rapidly grew into a community-supported agriculture operation that provides organic vegetables to hundreds of Austin families. This operation supplies produce to Whole Foods grocery stores and local restaurants, and it has expanded to other Texas cities like Dallas and San Antonio.

Hearing about operations like these gives me a tremendous amount of hope for the future of agriculture and humanity. They show our ingenuity, our ability to adapt to help feed a growing population in a sustainable way.

I know that more and more of these kinds of operations are appearing in the AgFirst District as well, and I appreciate your efforts to serve them. Your district has supported events for nontraditional producers, such as organic farmers, and you have expanded your outreach to these groups through your farmers market program. I commend you for your leadership in these areas, and I firmly believe that you will reap benefits from doing so. Not only are you expanding your customer base, you are also demonstrating to the world that the System continues to provide critical support to agriculture, giving it the opportunity to evolve to meet consumer demand and to accommodate greater diversity among producers.

And by serving small and beginning borrowers who might have difficulty obtaining loans elsewhere, the System is demonstrating what a government-sponsored enterprise is all about — supporting an industry that is vital to our nation and the well-being of our people.

We will always need to have farms that produce thousands of acres of grain, but local and organic products play an important role, too, by supplementing and diversifying the food supply available to consumers. And demand for these products has created exciting opportunities for small and beginning farmers, which, in turn, creates new opportunities for lenders.

Another item on the list of assumptions is that the diversity of the U.S. population will continue to grow, as well as the diversity of agriculture. By this, I mean not only racial, ethnic, and gender diversity among producers but also diversity in the industry itself. After all, agriculture is no longer strictly a rural enterprise. Because of consumer demand for local, organic, and value-added products, the location of farms, the size of farms, and even the products grown on them have become more diverse. By serving the producers of operations that vary widely by size, location, and commodity, agricultural lenders can diversify their portfolios and reduce the dangers of concentration risks.

I'd like to mention one final assumption from this list. The growing population of this planet will place unprecedented demands on the food supply. This is a challenge, of course, but for farmers and farm lenders, it's also a tremendous opportunity.

By meeting the credit needs of this new kind of farmer while continuing to meet the needs of large production agriculture, the Farm Credit System can help solve perhaps the most critical problem facing humanity — how to feed 9 billion people by 2050.

Although the farm economy will create some challenges in the months and years ahead, the world's growing population will ensure that farmers — as well as farm lenders — will have opportunities to grow and thrive.

I also realize that not all challenges facing the System are external ones. Territorial concurrence is an internal issue about which institutions differ. Should System institutions operate exclusively in their territories? Or should there be more intra-System competition? These are questions that we plan to explore in 2016, and we want your input. In the next few weeks, staff from our Office of Regulatory Policy will reach out to each district to try to schedule meetings next year to discuss this issue. We look forward to a productive discussion.

And now I'd like to conclude by saying that the Farm Credit System is agriculture's best-kept secret. As I mentioned two weeks ago in a speech to the Funding Corporation, most Americans have never heard of it and yet the System's network of lenders represents one of the largest financial entities in the country. At the end of June, its assets were worth $283 billion. But the real reason the System is the agriculture industry's best-kept secret is the contribution it has made to the industry.

The System is our nation's oldest government-sponsored enterprise. Next year it celebrates its 100th anniversary. Thanks in part to the funding that the System has provided to farmers, ranchers, and farm cooperatives, our nation's farm economy has flourished, providing food for our own people and much of the world. Every year since 1960, U.S. farmers and ranchers have exported more agricultural products than our nation has imported. This surplus helps counter our nation's trade imbalance.

This level of productivity was possible in part because the System was available to provide reliable, affordable credit to agriculture producers in good times and bad. The System is an incredible success story that the American public and our nation's policymakers need to hear. Others are trying to convince policymakers that the System has outlived its mission. We know better. Don't let others define you. Take your story to your local communities. Take your story to Congress.

It is crucial for the success of agriculture — and ultimately to the food supply of our nation and our world — that farmers and ranchers continue to receive the funding they need to succeed for generations to come.

Thank you.