Testimony of the Honorable Jill Long Thompson
Board Chair and Chief Executive Officer
Farm Credit Administration
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Committee on Agriculture
Subcommittee on Livestock, Rural Development, and Credit
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Introduction

Chairman Crawford, Ranking Member Costa, Members of the Subcommittee, I am Jill Long Thompson, Board Chair and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). On behalf of my colleagues on the FCA Board, Kenneth A. Spearman of Florida, Leland A. Strom of Illinois, and all the dedicated men and women of the Agency, I am pleased to participate in this hearing today.

FCA is an independent agency responsible for examining and regulating the banks, associations, and related entities in the Farm Credit System (FCS or System), including the Federal Agricultural Mortgage Corporation (Farmer Mac). The banks and associations of the FCS form a nationwide network of borrower-owned financial institutions that provide credit to farmers, ranchers, residents of rural communities, agricultural and rural utility cooperatives, and other eligible borrowers.

FCA Mission

As directed by Congress, FCA's mission is to ensure a safe, sound, and dependable source of credit and related services for agriculture and rural America. We accomplish this mission in two important ways.

First, we protect the safety and soundness of the FCS by examining and supervising all FCS institutions, including Farmer Mac, and we ensure that they comply with applicable laws and regulations. Our examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risk, as well as on the ability of its board and management to direct its operations. We also evaluate each institution's compliance with laws and regulations to ensure that it serves all eligible borrowers, including young, beginning, and small farmers and ranchers. If a System institution violates a law or regulation or operates in an unsafe or unsound manner, we use our supervisory and enforcement authorities to take appropriate corrective action.

Second, we develop policies and regulations that govern how System institutions conduct their business and interact with customers. Our policies and regulations protect System safety and soundness; implement the Farm Credit Act; provide minimum requirements for lending, related services, investments, capital, and mission; and ensure adequate financial disclosure and governance. We approve the corporate charter changes of System institutions, System debt issuance, and other financial and operational matters.

Through the oversight and leadership of the House and Senate Agriculture Committees, many important reforms were made to the Farm Credit Administration and the FCS as a result of the agricultural credit crisis of the 1980s. This included restructuring FCA as an independent arm's-length regulator with formal enforcement powers, providing borrower rights to System borrowers with distressed loans, and establishing the Farm Credit Insurance Fund (Insurance Fund) to protect System investors.

Since then, the Farm Credit System has restored its financial health and the public trust. Using our authority as an arm's-length regulator, we have contributed to the System's success by ensuring that System institutions adhered to safety and soundness standards. The Insurance Fund also helped by restoring investor confidence.

Both the System and FCA learned much during the crisis of the 1980s, and those lessons helped build a much stronger Farm Credit System, as well as a stronger regulator. We will continue to focus on ensuring that the System remains safe and sound by promulgating regulations, providing appropriate guidance, and maintaining strong and proactive examination and supervisory programs. With the dynamics and risks in the agricultural and financial sectors today, we recognize that FCS institutions must have the appropriate culture, governance, policies, procedures, and management controls to effectively identify and manage risks. Today the System is a dependable provider of credit to agriculture and rural America as intended by Congress.

Farm Credit System Mission

The FCS is a Government-sponsored enterprise (GSE) created by Congress in 1916 to provide American agriculture with a dependable source of credit. The System's banks and associations form a nationwide network of cooperatively organized banks and associations that are owned and controlled by their borrowers, serving all 50 States and the Commonwealth of Puerto Rico.

The System provides credit and other services to agricultural producers and farmer-owned agricultural and aquatic cooperatives. It also makes loans for agricultural processing and marketing activities, rural housing, farm-related businesses, rural utilities, and foreign and domestic companies involved in international agricultural trade. In addition, the System provides funding and discounting services to certain "other financing institutions" and forms partnerships with commercial banks to provide credit to agriculture and rural America through participations and syndications.

As required by law, System borrowers own stock or participation certificates in System institutions. The FCS had nearly 1.1 million loans and approximately 500,000 stockholders in 2013. Approximately 85 percent of the stockholders were farmers or cooperatives with voting stock. The remaining 15 percent were nonvoting stockholders, including rural homeowners and other financing institutions that borrow from the System. The U.S. Department of Agriculture's latest data show that the System's market share of farm debt was 41 percent, which slightly exceeds the 40 percent share held by commercial banks.

One of FCA's oversight roles is to ensure that the System, with its mission devoted to agriculture and rural America, maintains its presence in the agricultural marketplace to provide competitive and dependable credit for all eligible and creditworthy farmers, ranchers, and agricultural cooperatives. In fact, the System has maintained its mission service during the difficult markets of the past six years to help producers and rural America. When commodity prices soared in early 2008, System institutions stepped forward to meet the critical financing needs of the grain elevator industry. They met increased demands for financing machinery and higher input costs for producers. The FCS also helped Midwest borrowers affected by floods and worked with livestock producers, especially dairy and hog producers, as they made difficult decisions during stressful market conditions. Overall the System continued to have access to funds and was able to increase its lending to agriculture and rural America during a financial crisis and severe recession.

Condition of the FCS

The FCS remains fundamentally safe and sound and is well positioned to withstand the challenges facing agriculture. Although the near-term outlook for agriculture is generally favorable, uncertainty surrounding both the general and farm economies will present continuing challenges for the System.

The U.S. Department of Agriculture is projecting that net cash income will drop sharply in 2014. Crop prices declined significantly in 2013 in response to strong global crop production. Near-record U.S. corn and soybean plantings and a return to normal yields in 2014 could lead to further declines in grain and oilseed prices.

As a consequence of lower prices, margins for crop producers will be sharply lower, but the dairy and livestock sectors should see a significant improvement in profitability. Lower grain prices are also having a cooling effect on the farmland market, especially in the Midwest. Severe drought conditions in the West, especially in California, may also negatively affect System borrowers. While the current credit stress level in the System's loan portfolio is well within its risk-bearing capacity, the above-mentioned factors may adversely affect asset quality in 2014.

The System continues to grow at a moderate pace. As of March 31, 2014, gross loans totaled $204.6 billion, up $12.8 billion or 6.7 percent from March 31, 2013. Real estate mortgage lending was up $5.5 billion or 6.2 percent as demand for cropland continued in 2013, especially in the Midwest. Overall, real estate mortgage loans represent 46.1 percent of the System's loan portfolio. Agribusiness and production lending increased by $3.3 billion from the year before, and intermediate-term lending increased by $2.4 billion.

The System also continues to enhance its capital base. As of March 31, 2014, System capital equaled $43.7 billion, up from $39.6 billion the year before. The System's total capital-to-assets ratio was 16.6 percent as compared with 16.0 percent a year earlier. Moreover, more than 81 percent of total capital is in the form of earned surplus.

The increase in total capital is due in large part to the System's strong earnings performance. For the first quarter of 2014, the System reported net income of $1.1 billion. For the 2013 calendar year, the System reported net income of $4.6 billion. With the decline of 18 basis points in the interest rate on earning assets, net interest margin declined in the first quarter to 2.63 percent compared with 2.83 percent the year before. Higher average earning asset balances, up $15.1 billion year over year, helped offset the decline in net interest margin. While the System has been able to take advantage of the low interest rate environment, its ability to continue to lower its cost of debt relative to asset pricing is limited. Some compression of net interest spread is expected as interest rates change and assets prepay or reprice.

Credit quality in the System's loan portfolio continues to be strong. As of March 31, 2014, nonperforming loans totaled $2.1 billion, or 1.01 percent of gross loans, as compared with $2.7 billion, or 1.41 percent, for the same quarter a year ago. In comparison to total capital, nonperforming loans represented 4.7 percent at quarter-end. High feed costs, which challenged livestock, poultry, and dairy producers through much of 2013, have moderated as a result of the substantial drop in crop prices. Combined with strong product pricing, profit margins for these sectors are substantially higher. Other sectors such as the forestry and nursery industries have also seen a drop in nonaccrual rates as the U.S. housing market continues to strengthen.

The System continues to have reliable access to the debt capital markets. Investor demand for all System debt products has been positive, allowing the System to continue to issue debt on a wide maturity spectrum at very competitive rates. Even as the Federal Reserve started to slowly taper its quantitative easing policy at the end of 2013, risk spreads and pricing on System debt securities remained favorable relative to corresponding U.S. Treasuries. Further strengthening the System's financial condition is the Insurance Fund, which holds more than $3.6 billion. Administered by the Farm Credit System Insurance Corporation, this fund protects investors in Systemwide consolidated debt obligations.

System banks also maintain liquidity reserves to ensure they can withstand market disruptions. As of March 31, 2014, the System's liquidity position equaled 183 days, significantly above the 90-day regulatory minimum.

A Changing Risk Profile in Agriculture

The high grain prices of the past few years led to strong earnings for grain and soybean farmers. High grain prices had the inverse effect on the earnings of livestock and dairy producers, constricting their profit margins by driving up their feed costs.

The tables have now turned, however. The large U.S. corn and soybean crops in 2013 and the potentially large crops in 2014 have caused prices for these crops to decline considerably. As a result, the profit margins for livestock and dairy producers have expanded as the profit margins of grain and soybean farmers have constricted. Crop insurance played an important role in supporting grain and soybean farmers' income in 2013, but the level of support it will provide in the future is unclear.

The reduced profit margins in the crop sector are not expected to lead to significant credit problems in the near future because many grain farmers have experienced several years of good earnings and should have the resources necessary to get them through some lean times. Nevertheless, grain farmers who rent most of the land they farm may face greater financial stress than those who have no land rental costs.

Farmland values in the Midwest rose rapidly during the past several years because of high grain prices and historically low interest rates. Most observers agreed that these elevated farmland values were not sustainable because grain prices and interest rates would likely revert to more sustainable levels, leading to an adjustment in farmland prices. Surveys conducted by several Federal Reserve Banks and Iowa State University indicate that farmland values are adjusting.

Fortunately, farm real estate mortgage underwriting has been conservative among Farm Credit System institutions as well as commercial banks, according to colleagues from other financial regulators with whom we discuss common issues regularly. Consequently, we believe that most FCS institutions will not face significant losses because of adjustments in farmland prices.

FCA staff monitors developments in the farmland market closely, and our examiners have implemented a program for examining the collateral risk management at each Farm Credit institution. In addition, we monitor System real estate mortgage loan-to-value ratios on a quarterly basis. The FCA Board receives semiannual staff reports on the farmland market and loan-to-value ratios at Farm Credit institutions.

Examination Programs for FCS Banks and Associations

FCA is responsible for regulating and supervising the banks, associations, and related entities that compose the Farm Credit System. Our examination and oversight programs provide strategic, proactive risk supervision of the System. In conducting our institution-specific, risk-based oversight and examination activities, we assign highest priority to institutions that present the greatest risk.

We also perform nationally focused examinations that target specific issues and operational areas to monitor the condition and operations of the System as a whole. We actively monitor risks that may affect groups of System institutions or the entire System, including risks from the agricultural, financial, and economic environment.

Through our oversight, we require System institutions to have the programs, policies, procedures, and controls to effectively identify and manage risks. Our oversight program also requires compliance with laws and regulations. When institutions are either unable or unwilling to address unsafe and unsound practices or to comply with laws and regulations, we take appropriate supervisory or enforcement action. We use a comprehensive regulatory and supervisory framework to ensure the System's safety and soundness. FCS institutions, on their own and in response to our efforts, continue to improve their risk management systems.

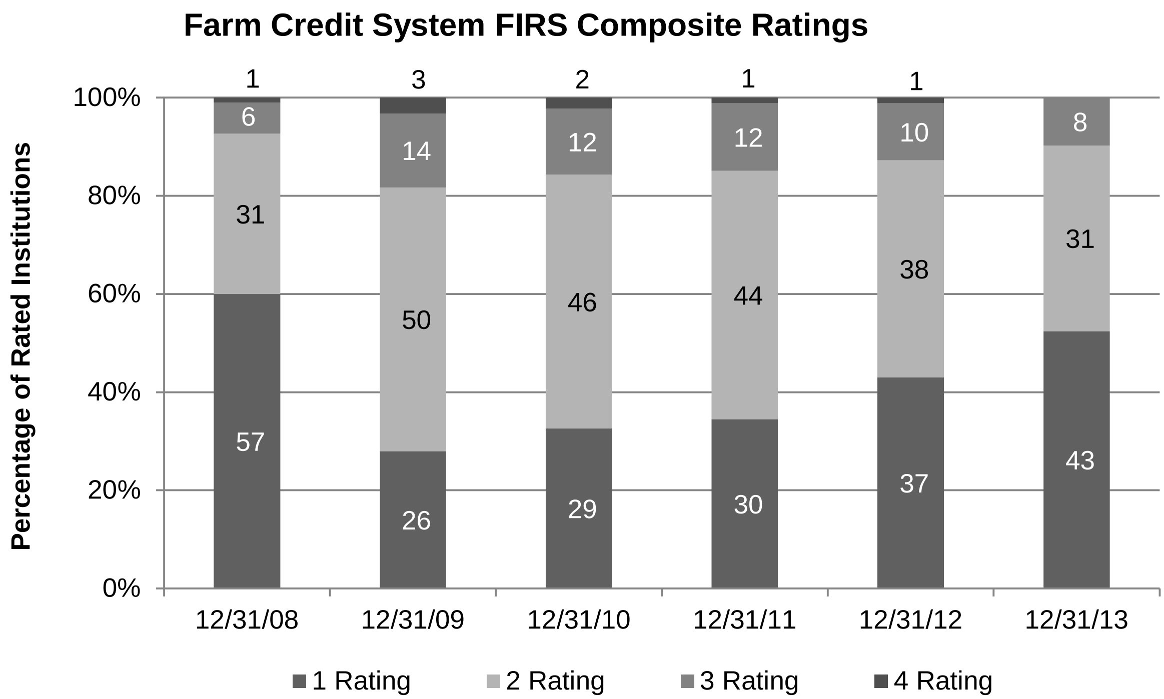
FCA uses the Financial Institution Rating System (FIRS) to assess the safety and soundness threats to each System institution. Similar to the systems used by other Federal financial regulators, the FIRS is a CAMELS-based system, with component ratings for capital, assets, management, earnings, liquidity, and sensitivity, all factoring into an overall composite rating. System institutions are assigned component and composite ratings based on FCA's evaluation of quantitative and qualitative factors. FIRS ratings range from 1 for a sound institution to 5 for an institution that is likely to fail.

Although the System's financial condition remains sound, a small number of individual institutions display some weaknesses. These weaknesses stem from several factors that have adversely affected some System borrowers:

- The slow pace of economic recovery
- Volatile commodity prices
- Drought in the western United States
- Damaging diseases in the citrus and pork sectors

As the System's regulator, we have increased supervisory oversight and dedicated additional resources to institutions experiencing stress. As of December 31, 2013, eight System institutions had a composite FIRS rating of 3. While these institutions represent about 2 percent of System assets and do not meaningfully affect the System's consolidated performance, they require significantly more resources to oversee.

The chart below includes the System banks and their affiliated associations. The figures in the bars reflect the number of institutions by FIRS rating.



Source: FCA's FIRS Ratings Database.

Regulatory Activities

Congress has given the FCA Board statutory authority to establish policy, prescribe regulations, and issue other guidance to ensure that System institutions comply with the law and operate in a safe and sound manner. We are committed to developing balanced, flexible, and legally sound regulations.

Over the past couple of years, we have revised our regulations to accomplish the following objectives:

- To require each System institution's business plan to include strategies and actions to serve all creditworthy and eligible persons in the institution's territory. In addition, the regulation encourages institutions to serve nontraditional customers, such as women and minorities, who often operate within local food systems by producing organic or specialty crops on small farms. The regulation also seeks to achieve diversity and inclusion in the workforce of System institutions.
- To enhance System disclosures of senior officer compensation and supplemental benefit programs.
- To ensure that System institutions maintain effective policies to measure and manage exposure to single counterparties, industries, and market segments, and to large complex loans.
- To ensure that System funding and liquidity requirements are appropriate and to ensure that the discounts applied to investments reflect their marketability.
- To allow System institutions to purchase eligible agricultural loans from the Federal Deposit Insurance Corporation.

- To ensure that prudent practices are in place for the safe and sound management of System investment portfolios.
- To remove all requirements related to nonbinding, advisory votes at System institutions on senior officer compensation.
- To establish a regulatory framework for the reporting of System accounts and exposures to FCA. The revisions reaffirm our authority to collect data on System institution accounts and exposures, including data on shared assets.
- To establish standards for Farmer Mac's capital planning process. The revised process emphasizes the quality and level of capital and annual stress testing.
- To increase the level and quality of assets held in Farmer Mac's liquidity reserve.

Currently, we are working on regulatory projects to accomplish these additional objectives:

- To enhance our risk-based capital adequacy framework to more closely align it with that of other Federal banking agencies and the Basel Accord. We published a notice of proposed rulemaking to solicit comments on amending our regulations to replace the current core and total surplus capital standards with a "Tier 1/Tier 2" capital framework.
- To implement the requirements of the Dodd–Frank Wall Street Reform and Consumer Protection Act by imposing margin requirements on noncleared derivatives transactions and removing references to credit ratings.
- To clarify and strengthen the standards-of-conduct requirements for System directors, employees, and agents.
- To seek public input on FCA regulations that may duplicate other requirements, are not effective in achieving the stated objectives, are not based on law, or impose burdens that are greater than the benefits received.
- To clarify and enhance stockholder voting procedures.
- To revise regulatory requirements for mergers or consolidations of banks or associations.
- To strengthen the safety and soundness of the investment activities of System banks by more accurately reflecting the risk in particular investments, and to comply with a provision of the Dodd–Frank Act by replacing credit rating requirements with other standards of creditworthiness.
- To ensure appropriate and effective risk governance and board oversight at Farmer Mac, and to clarify standards-of-conduct and conflict-of-interest requirements.
- To remove reliance on credit ratings from investment eligibility regulations pertaining to Farmer Mac and to maintain the quality and availability of Farmer Mac's liquid investments.

Corporate Activities

The number of FCS institutions has declined over the years as a result of bank and association mergers. Generally, System institution mergers result in larger, more cost-efficient and better-capitalized institutions with broad, diversified asset bases, both by geography and commodity.

However, these mergers also increase the complexity of the continuing institutions. The increased complexity places greater demands on both FCA staff resources, as well as the level of expertise required of staff, particularly in areas of regulation, policy, examination, and legal interpretation. As of January 1, 2014, the System consisted of the following:

- Seventy-eight direct-lender associations
- Three Farm Credit Banks and one Agricultural Credit Bank
- Five service corporations that provide support, technology, leasing, human capital, and other services
- A funding entity that markets the securities—chiefly bonds and discount notes—that the banks sell in the capital markets to raise loan funds
- A GSE with the mission of providing a secondary market for agricultural real estate and rural housing mortgage loans

Federal Agricultural Mortgage Corporation

Congress established Farmer Mac in 1988 to provide a secondary market for agricultural mortgage and rural home loans to improve the availability of cost-effective long-term credit and liquidity to America's farmers, ranchers, and rural communities. Farmer Mac creates and guarantees securities and other secondary market products that are backed by mortgages on farms and rural homes, including certain USDA guaranteed loans. Loan originators that participate in Farmer Mac's secondary market programs include community banks, Farm Credit System institutions, mortgage companies, commercial banks, insurance companies and credit unions. The 2008 Farm Bill expanded Farmer Mac's program authorities by allowing it to purchase and guarantee securities backed by eligible rural utility loans made by cooperative lenders.

Through a separate office required by statute (the Office of Secondary Market Oversight), FCA examines, regulates, and oversees Farmer Mac's operations and its safety and soundness. As the secondary market GSE devoted to agriculture and rural America, Farmer Mac has the statutory authority to, in extraordinary circumstances, issue obligations to the U.S. Treasury Department, not to exceed $1.5 billion, to fulfill the guarantee obligations of its guaranteed securities. The Insurance Fund does not back Farmer Mac's securities, and the System is not liable for any Farmer Mac obligations.

After sustaining losses on liquidity investments during the 2008 financial crisis, Farmer Mac continues to replenish capital and strengthen its operations and risk-bearing capacity to advance its statutory mission. Over the past several quarters, Farmer Mac's capital position has steadily improved, with healthy core earnings growth and recent issuances of high-quality preferred stock. As of March 31, 2014, Farmer Mac's core capital totaled $664.0 million, which exceeded its statutory requirement of $462.5 million. As a result, capital surplus grew to $261.0 million, up from $155.6 million as of March 31, 2013.

New business volume growth is steady. The total portfolio of loans, guarantees, and commitments grew by 5 percent from March 31, 2013, to $14.1 billion on March 31, 2014. Farmer Mac recently reported that small farm loans contributed 44 percent of the volume related to its new Farm & Ranch program. Despite the decreasing number of small farms, Farmer Mac has seen an overall increase in the dollar volume and number of small farm loans in its programs.

Credit quality indicators reflect the strength in the agricultural and rural utility sectors and Farmer Mac's commitment to strong underwriting standards. As of March 31, 2014, Farmer Mac's 90-day delinquencies were $29.4 million, or 0.56 percent of Farm & Ranch volume, compared with $39.7 million, or 0.83 percent, as of March 31, 2013. Real estate owned as of March 31, 2014, was $2.5 million, down from $4.4 million a year earlier. Farmer Mac reported no delinquencies in its pools of rural utility cooperative loans. On March 31, 2014, Farmer Mac's allowance for losses totaled $14.0 million, compared with $14.3 million on March 31, 2013.

Farmer Mac continues to enjoy reliable access to the debt capital markets to support its mission of providing financing and liquidity to agriculture and rural markets. To improve its financial flexibility in the event of a financial or market disruption, Farmer Mac has taken significant measures to increase the quality and liquidity of its $2.5 billion investment portfolio.

Serving Young, Beginning, and Small Farmers and Ranchers

System institutions are required to develop programs and make special efforts to serve young, beginning, and small (YBS) farmers and ranchers. In 2013, the System continued to show gains in loan dollars outstanding and loan numbers outstanding to YBS producers. In addition, from 2012 to 2013, the number of new loans made to young farmers went up by 2.3 percent, and the number of new loans made to beginning farmers went up by 5.0 percent.

Despite these gains, YBS results as a percentage of the System's total farm loans have either declined or remained flat over the past few years. These results likely reflect the shrinking pool of YBS farmers in the United States. Because of the high costs of starting a farm, fewer people are entering agriculture. Over the years, farms have gotten bigger, and the average age of farmers has gone up.

FCA issued a bookletter in August 2007 to encourage institutions to seek ways to better serve YBS borrowers. The bookletter provides institutions with more flexibility to lend to YBS borrowers and encourages them to use credit enhancements to allow more YBS borrowers to qualify for credit. Credit enhancements for YBS borrowers may include

- lower rates or fees for YBS borrowers,
- differential underwriting standards, and
- USDA loan guarantees.

In response to this guidance, more institutions are committing capital to assist in their YBS lending, and more are using advisory committees to update YBS policies and procedures. Many institutions have stepped up their YBS outreach efforts and their coordination with outside parties or organizations to serve YBS producers.

In addition to providing credit to YBS borrowers, FCS institutions may offer other financial services to YBS borrowers, and many institutions provide special training and educational programs for them.

Our efforts to encourage System institutions to emphasize diversity and inclusion and to serve producers of local and regional foods also benefit YBS producers. In 2012, to ensure the System fulfills its congressional mission to serve all eligible, creditworthy borrowers, we issued a regulation requiring institutions to develop human capital and marketing plans that promote diversity and inclusion. Because many small and beginning farmers belong to underrepresented groups, this regulation helps strengthen service to YBS borrowers. Likewise, a bookletter we issued in 2012 to provide guidance regarding service to local and regional foods producers also benefits YBS borrowers because many of these producers would be classified as young, beginning, or small.

Working with Financially Stressed Borrowers

Risk is an inherent part of agriculture, and the causes of risk are many:

- Adverse weather
- Changes in Government programs
- International trade issues
- Fluctuations in commodity prices
- Crop and livestock diseases

These risks can sometimes make it difficult for borrowers to repay loans. The Farm Credit Act provides System borrowers certain rights when they apply for loans and when they have trouble repaying loans. For example, the act requires FCS institutions to notify borrowers of the right to seek restructuring of loans before the institutions begin foreclosure. It also provides borrowers an opportunity to seek review of certain credit and restructuring decisions. When a System institution acquires agricultural property through liquidation, the Farm Credit Act also provides borrowers the opportunity to buy or lease back their former properties.

FCA enforces the borrower rights provisions of the Farm Credit Act and examines institutions to make sure that they are complying with these provisions. We also receive and review complaints from borrowers who believe their rights have been denied. Through these efforts, we ensure compliance with the law and help FCS institutions continue to provide sound and constructive credit and related services to eligible farmers and ranchers.

Conclusion

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System and Farmer Mac remain financially sound and focused on serving agriculture and rural America. While we are proud of our record and accomplishments, we remain committed to excellence, effectiveness, and cost efficiency, and we will remain focused on our mission of ensuring a safe, sound, and dependable source of credit for agriculture and rural America. This concludes my statement. On behalf of my colleagues on the FCA Board and at the Agency, I thank you for the opportunity to share this information.