

**Testimony of the Honorable Glen R. Smith
Board Chairman and Chief Executive Officer
Farm Credit Administration
Before the Subcommittee on Agriculture,
Rural Development, Food and Drug Administration,
and Related Agencies
U.S. House of Representatives Committee on Appropriations
February 12, 2020**

Mr. Chairman and Members of the Subcommittee, I am Glen R. Smith, board chairman and CEO of the Farm Credit Administration (FCA or agency). On behalf of my board colleague Jeffery S. Hall of Kentucky and all the dedicated men and women of the agency, I am pleased to provide this testimony. Before I discuss the agency's role, responsibilities, and budget request, I would like to thank the subcommittee staff for its assistance during the budget process.

Congress established and structured the Farm Credit System (FCS or System) to provide farmers and rural communities access to financial institutions where they have a voice in the decision-making process to ensure the financial needs of rural America are addressed. The System is made up of banks, associations, and several service corporations, including the Federal Farm Credit Banks Funding Corporation.

Congress also established the Federal Agricultural Mortgage Corporation (Farmer Mac) to increase access to affordable credit for American agriculture and rural communities. Farmer Mac provides a secondary market for agricultural real estate mortgage loans, rural housing loans, and rural utility cooperative loans.

FCA was created to ensure the financial viability of the System and to ensure that the institutions follow their legal obligations. Because the System institutions and Farmer Mac are uniquely structured, FCA has developed regulatory and oversight approaches that are designed to fit these structures. In the case of Farmer Mac, that includes a separate FCA office, the Office of Secondary Market Oversight. As a result of the collective efforts of the System and Farmer Mac — under the supervision of FCA — U.S. agriculture and rural utilities receive hundreds of billions of dollars in financing every year. In carrying out its important mission, FCA does not receive a federal appropriation. Our administrative expenses come from funds that are assessed and collected annually from the government-sponsored enterprises we regulate and examine — the System and Farmer Mac.

For fiscal year (FY) 2021, we are submitting a proposed total budget request of \$81,010,000. Our proposed budget for FY 2021 includes current and prior-year assessments of \$80,400,000 from System institutions, including Farmer Mac, and \$610,000 from anticipated reimbursable work for the Farm Credit System Insurance Corporation, the U.S. Department of Agriculture, and the National Consumer Cooperative Bank. Of this budget amount, 86.5% is for salaries, benefits, and related personnel costs.

A key factor driving the FY 2021 budget is our need to hire and train qualified individuals to replace the many employees — especially examiners and risk analysts — who have begun to retire. Our examiner commissioning program takes three to five years to complete. Approximately a third of our examination staff is eligible to retire within the five-year planning horizon, and half of the non-examination staff is eligible to retire during the same planning

horizon. We must ensure that our staff has the skills it needs to address changes in the agricultural industry and the complexities of agricultural finance. Also, we continue to dedicate more resources to acquire and implement technology. We anticipate a continued increase in the use of technological, business intelligence, and data tools by agency staff. As the pace of technological change increases, we also need to invest in cybersecurity and automating manual processes. The funding we have requested for FY 2021 will help us hire, train, and retain the people we need to properly examine, oversee, and regulate the System.

Mission of the Farm Credit Administration

As directed by Congress, FCA's mission is to ensure that System institutions and Farmer Mac are safe, sound, and dependable sources of credit and related services for all creditworthy and eligible persons in agriculture and rural America. We accomplish our 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 ensuring that the institutions comply with applicable laws and regulations. Our examinations and oversight strategies focus on an institution's financial condition and any material existing or potential risks, 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 and evaluate whether it serves all eligible borrowers, including young, beginning, and small farmers and ranchers. If a regulated institution violates a law or regulation or operates in an unsafe or unsound manner, we use our supervisory and enforcement authorities to ensure appropriate corrective action is taken.

Second, we develop policies and regulations that govern how System institutions and Farmer Mac conduct their business and interact with customers. Our policy and regulation development are focused on protecting safety and soundness; implementing the Farm Credit Act; providing minimum requirements for lending, related services, investments, capital, and mission; and ensuring adequate financial disclosure and governance. The policy development program includes approval of corporate charter changes, System debt issuance, Farmer Mac's secondary market operations, and other financial and operational matters.

Examination Programs for FCS Banks, Associations, and Farmer Mac

To help ensure the safety and soundness of FCS institutions and Farmer Mac, FCA uses examination and supervision processes to address material and emerging risks at the institution level and across the System. We base our examination and supervision strategies on institution size, existing and prospective risk exposure, and the scope and nature of each institution's business model. We monitor agricultural, financial, and economic risks that may affect groups of institutions or the entire System, including Farmer Mac. Given the increasing complexity and risk in the agricultural and rural utility financial system and the human capital challenges at FCA, we continue to implement initiatives to improve operations, increase examination effectiveness, and enhance staff expertise in key examination areas.

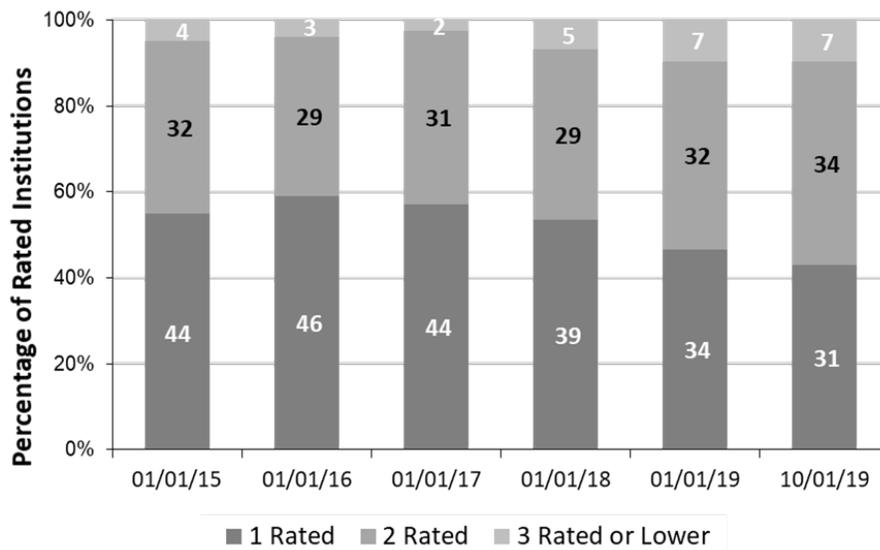
The frequency and depth of examination activities vary based on risk, but each System institution is examined at least once every 18 months and receives a summary of examination activities and a report on its overall condition. In Farmer Mac's case, the examination is annual. FCS institutions and Farmer Mac are required to have effective loan underwriting and loan administration processes to properly manage assets and liabilities, to establish high

standards for governance, and to provide transparent disclosures to shareholders. Our examination and supervision program promotes accountability in FCS institutions by working to ensure institutions identify and manage risks. When necessary, we use our enforcement powers to require institutions to change their policies and practices to correct unsafe or unsound conditions, weak business practices, or violations of law or regulations.

To assess the safety and soundness of each regulated institution, we use our Financial Institution Rating System (FIRS). The FIRS provides a framework of ratings to help examiners evaluate significant financial, asset quality, and management factors in a consistent way across the System. FIRS ratings range from 1 for a very sound institution to 5 for an institution that is likely to fail. As the chart on the following page indicates, the System remains financially strong overall. Currently, institutions are well capitalized, and the FCS and Farmer Mac do not pose material risk to investors in FCS and Farmer Mac debt, to the Farm Credit System Insurance Corporation, or to FCS institution and Farmer Mac stockholders.

Although the System's condition and performance remain satisfactory overall, several institutions are experiencing stress and require special supervision. We have increased supervisory oversight at these institutions and dedicated additional resources in particular to the seven institutions rated 3 or lower. Although these institutions represent less than 2.5% of System assets and do not materially affect the System's consolidated performance, they require significantly greater agency resources to oversee. Factors causing the stress include ongoing weakness in specific agricultural sectors as well as institution-specific issues in loan underwriting, risk identification, internal controls, and board oversight and governance. As of September 30, 2019, five FCS institutions were under supervisory actions, but no FCS institutions were under formal enforcement actions, in conservatorship, or in receivership.

FCS Financial Institution Rating System (FIRS) composite ratings



Source: FCA's FIRS Ratings Database.

Note: This chart reflects ratings for only the System's banks and direct-lending associations; it does not include ratings for the System's service corporations, Farmer Mac, or the Federal Farm Credit Banks Funding Corporation. Also, the numbers in the bars indicate the number of institutions by FIRS rating.

Regulatory and Corporate Activities

Regulatory activities — Congress has given the FCA board statutory authority to prescribe regulations to ensure that FCS institutions comply with the law and operate in a safe and sound manner. We are committed to developing balanced, flexible, and legally sound regulations. Current regulatory projects outlined in the agency's fall 2019 Unified Regulatory Agenda include the following:

- Revising investment eligibility to include certain obligations unconditionally guaranteed by the USDA
- Clarifying or changing the amortization limits for agricultural credit associations and production credit associations
- Revising the criteria for reinstating nonaccrual loans
- Revising the eligibility criteria for outside directors
- Clarifying and correcting regulatory capital and related regulations
- Clarifying the disclosure and servicing requirements in the borrower rights regulations
- Clarifying and strengthening standards-of-conduct regulations
- Revising the appraisal regulations for current credit and economic conditions
- Revising the regulations on compensation of bank directors
- Following up on the input we received on young, beginning, and small farmer programs and reporting
- Revising the questions-and-answers guidance on flood insurance
- Reviewing the cooperative principles and practices at System institutions

Corporate activities — Because of mergers, the number of FCS institutions has declined over the years, but their complexity has increased, placing greater demands on both examination staff resources and expertise. Generally, these mergers have resulted in more cost-efficient and better-capitalized institutions with broader, more diversified asset bases, both by geography and commodity. As of December 31, 2019, the System had 68 direct-lender associations, 4 banks, 5 service corporations, and 2 special-purpose entities.

Rural business investment companies — The 2002 Farm Bill created the Rural Business Investment Program for leveraged rural business investment companies (RBICs) and gave the secretary of agriculture the authority to license and examine them. The 2008 Farm Bill modified the program to allow for nonleveraged RBICs and to permit System institutions to form and invest in nonleveraged RBICs. Under an interagency agreement with USDA, we will review and provide recommendations for seven RBIC applications over a five-year timeframe. We agreed to expend no more than 1,800 hours, or 90% of one full-time-equivalent staff position, to complete the RBIC assignments during a fiscal year.

Condition of the FCS

The FCS continues to be fundamentally safe and sound, and it remains well positioned to respond to the credit needs of U.S. agriculture. For FY 2019, the System reported strong financial results, including steady earnings, higher capital levels, and manageable portfolio credit risk. FCS banks had reliable access to debt capital markets and maintained liquidity levels well above the 90-day regulatory minimum.

2019 was a difficult year for many U.S. farmers and ranchers. Trade uncertainties, large commodity supplies, and weather extremes affected farm prices and reduced producer returns for key commodities. Several years of declining producer cash flows have depleted working capital and elevated borrowing needs. Although crop insurance indemnities, farm programs, and Market Facilitation Program payments have provided some financial protection, the level of support varies by region and commodity.

With large global supplies and “normal” weather, major crop prices in 2020 are expected to remain low. This could limit attractive price opportunities for U.S. farmers. Livestock and dairy returns are likely to be generally positive in the near term but could be further supported by trade developments. High-cost producers and those with significant leverage will continue to face significant financial pressure.

The System grew at a modest pace for the 12 months ending September 30, 2019. Gross loans equaled \$276.1 billion, up \$11.1 billion or 4.2% from a year ago. Real estate mortgage lending was up \$5.9 billion or 4.8%. Farmland values are generally steady, with some notable regional weaknesses and strengths. This has allowed borrowers to restructure their balance sheets to boost working capital levels. In total, real estate mortgage loans represent about 47% of the System’s loan portfolio. Production and intermediate-term lending increased by \$2.4 billion or 4.7% from the year before, and agribusiness lending for processing and marketing increased by \$2.8 billion or 11.6%.

The System also continues to benefit from a strong capital base, which enhances its risk-bearing capacity at a time when System borrowers in certain agricultural sectors face significant financial stress. As of September 30, 2019, System total capital equaled \$62.4 billion, up from \$58.2 billion a year before. The System’s total capital-to-assets ratio was 17.6% as compared with 17.4% a year earlier. Overall, 79.1% of total capital is in the form of retained earnings.

The increase in total capital is due in large part to the System’s strong earnings performance. For the first nine months of calendar year 2019, the System reported net income of \$4.1 billion compared with \$4.0 billion for the same period the previous year. Net interest margin was 2.41% compared with 2.45% during the first nine months of 2018.

Despite the challenges facing agriculture, credit quality in the System’s loan portfolio is sound. As of September 30, 2019, nonperforming assets totaled \$2.5 billion, or just 0.92% of gross loans. Relative to total capital, nonperforming assets represented 4.1% at quarter-end. In comparison, nonperforming assets represented 11.6% of capital at year-end 2010.

The System continues to have reliable access to the debt capital markets. Investor demand for all System debt products remains positive, allowing the System to continue to issue debt on a wide maturity spectrum at competitive rates.

With a balance of \$5.1 billion as of the third quarter 2019, the Farm Credit Insurance Fund further strengthens the System’s financial condition. 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 September 30, 2019, the System’s liquidity position equaled 177 days, significantly above the 90-day regulatory minimum required for each FCS bank.

Condition of Farmer Mac

Congress established Farmer Mac in 1988 to create a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac has authority to create and guarantee securities and other secondary market products that are backed by agricultural real estate mortgages and rural home loans, USDA-guaranteed farm and rural development loans, and rural utility cooperative loans. As mandated by statute, we have a separate office — the Office of Secondary Market Oversight — through which we regulate, examine, and supervise Farmer Mac's operations.

Farmer Mac is committed to enhancing the availability of reasonably priced credit to agriculture and rural America through its secondary market activities. Under specific circumstances defined by statute, Farmer Mac may issue obligations to the U.S. Treasury Department, not to exceed \$1.5 billion, to fulfill the guarantee obligations on Farmer Mac guaranteed securities. Farmer Mac is not subject to any intra-System agreements and, unlike System banks, is not jointly and severally liable for Systemwide debt obligations. Moreover, the Farm Credit Insurance Fund does not back Farmer Mac's debt.

As measured using generally accepted accounting principles (GAAP), net income available to common stockholders in FY 2019 (ended September 30) was down 8.59% from FY 2018 to \$84.1 million. The decrease was due to an after-tax decrease in the fair value of undesignated financial derivatives, an after-tax decrease in net interest income, and an after-tax increase in operating expenses.

Core earnings, a non-GAAP measure based more on cash flow, were up by 10.1% over FY 2018 to \$89.7 million. Core earnings differ from net income primarily by excluding the effects of fair value fluctuations that are expected to have no impact on Farmer Mac's financial condition, leading to a more cashflow-based depiction of the financial performance of Farmer Mac. The increase was primarily driven by an after-tax increase in net effective spread. The increase was partially offset by increases in operating expenses related to technology and business infrastructure investments, and increased staffing.

Net effective spread for the third quarter of 2019 decreased to 90 basis points, down from 93 basis points for the same quarter 12 months earlier. Earnings were also up due to growth in program volume, as well as continued improvements in LIBOR-based short-term funding costs for floating rate assets indexed to LIBOR. As of September 30, 2019, Farmer Mac's core capital totaled \$793.3 million, which exceeded its statutory requirement of \$608.4 million. The total portfolio of loans, guarantees, and commitments grew 7.1% to \$20.9 billion. In FY 2019, the quantity and quality of Farmer Mac's capital remained satisfactory relative to its risk profile.

Credit quality in all program business lines remained satisfactory. Credit risk was manageable, and adversely classified volume remained stable. As of September 30, 2019, substandard loans were 3.9% of total direct credit exposure, up 0.8% from a year earlier. Loans more than 90 days delinquent increased to 0.81% compared with 0.53% in the prior year.

Conclusion

We at FCA remain vigilant in our efforts to ensure that the Farm Credit System, including Farmer Mac, remains financially sound and focused on serving agriculture and rural America. We will continue our commitment to excellence, effectiveness, and cost efficiency and will

remain focused on our mission of ensuring that System institutions and Farmer Mac are safe, sound, and dependable sources of credit for agriculture and rural America. Our budget proposal identifies our goals and the performance measures we have developed to help ensure that we efficiently and effectively use our resources. It is our intent to stay within the constraints of our FY 2021 budget as presented while ensuring we attract and retain the staff needed to accomplish our mission. We will continue our efforts to be good stewards of the resources entrusted to us.