Farm Credit Administration
2004 Annual Report

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Statement of the Chairman and CEO

January 2005

Dear Reader,

On behalf of the Farm Credit Administration (FCA or Agency) Board and the dedicated employees of the Agency, I am pleased to present our *2004 Annual Report on the Farm Credit System*.

The FCA is the independent Federal agency responsible for examining and regulating the Farm Credit System (FCS or System), a nationwide network of borrower-owned financial institutions and service organizations that provide credit and related services to agricultural producers and their cooperatives.

FCA's role is to ensure that the System remains a safe, sound, and dependable source of credit for agriculture and rural communities. We accomplish this by conducting safety and soundness examinations of each System institution, including an assessment of whether they are meeting their mission to serve agriculture and rural America. The Agency also develops and adopts regulations and other guidelines that govern the activities of System institutions.

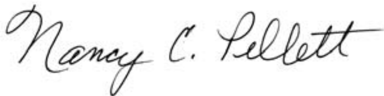
In 2004, the System again achieved an excellent level of performance. FCA examinations concluded that System institutions are fundamentally sound in all material respects. Capital and earnings reached all-time highs, and asset quality remained strong.

A matter that caused much discussion in the System, the agricultural community, and Congress was the August 3, 2004 notification to FCA by the Board of Directors of the Farm Credit Services of America, ACA (ACA) of their intent to terminate the ACA's status as a System institution to become a subsidiary of Rabobank International. While unusual, termination of System status is permissible under the Farm Credit Act of 1971, as amended. FCA was fully prepared to carry out its role under the statute and FCA regulations; however, the ACA board did not proceed with termination. Nevertheless, we are closely studying the issues that arose from the event.

Throughout my tenure as the Chairman and CEO, I will be a strong advocate for agriculture and rural communities. Vibrant towns, excellent schools, and a range of opportunities are critical factors in the success of today's farmers and ranchers, and in ensuring that young men and women are able to choose agriculture as a profession.

My fellow Board Members and I are committed to ensuring that the Agency remains a strong yet fair regulator for the System. If you have any comments or questions, please contact me at (703) 883-4008.

Sincerely,



Nancy C. Pellett
Chairman and Chief Executive Officer
Farm Credit Administration

Farm Credit Administration Organization and Mission

The Farm Credit Administration is an independent agency within the executive branch of the U.S. Government responsible for regulating and supervising the banks, associations, and related entities in the Farm Credit System, including the Federal Agricultural Mortgage Corporation (Farmer Mac). The FCS is a nationwide network of borrower-owned financial institutions that provide credit to farmers, ranchers, and producers or harvesters of aquatic products, farm-related service businesses, rural homeowners, agricultural and aquatic cooperatives, and rural utilities. Farmer Mac is the government-sponsored enterprise that provides a secondary market for agricultural real estate and rural housing mortgage loans.

Originally created by a 1933 executive order of President Franklin D. Roosevelt, today's FCA derives its powers and authorities from the Farm Credit Act of 1971, as amended (Farm Credit Act or Act). The U.S. Senate Committee on Agriculture, Nutrition, and Forestry and the U.S. House of Representatives Committee on Agriculture oversee FCA and the FCS.

FCA's mission is to ensure a safe, sound, and dependable source of credit and related services for agriculture and rural America. We do this in two specific ways. First, we conduct examinations of Farm Credit System institutions to monitor and oversee the safety and soundness of their ongoing activities. These examinations also focus on whether System institutions are meeting their public mandate to serve all eligible borrowers. Second, we approve corporate charter changes and research, develop, and adopt 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 its operations are unsafe or unsound, FCA may use its enforcement authority to ensure that the problem is corrected. FCA also protects the rights of borrowers, issues and changes the charters of FCS institutions, reports to Congress on the financial condition and performance of the FCS, and approves the issuance of System debt obligations.

The Agency maintains its headquarters and a field office in McLean, Virginia. It also has field offices in Bloomington, Minnesota; Dallas, Texas; Denver, Colorado; and Sacramento, California.

The FCA Board

FCA policy and its regulatory agenda are established by a full-time, three-person Board, whose members are appointed by the President of the United States with the advice and consent of the Senate. They serve six-year terms and may not be reappointed after serving full terms or more than three years of previous members' terms. The President designates one member as Chairman of the Board, who serves until the end of his or her own term. The Chairman also serves as FCA's Chief Executive Officer (CEO).

Nancy C. Pellett

Chairman and CEO

Nancy C. Pellett is Chairman and CEO of the Farm Credit Administration. Ms. Pellett was appointed to a six-year term on the three-member FCA Board by President George W. Bush on November 14, 2002; she was designated Chairman on May 22, 2004. Her term expires on May 21, 2008.

Ms. Pellett also serves as a member of the Board of Directors of the Farm Credit System Insurance Corporation. The Insurance Corporation, which is an independent U.S. Government corporation, is responsible for ensuring the timely payment of principal and interest on insured notes, bonds, debentures, and other obligations issued on behalf of Farm Credit System banks. The Insurance Corporation was established on January 6, 1988, with enactment of the Agricultural Credit Act of 1987.

Ms. Pellett brings to her position on the FCA Board extensive experience in production agriculture and agribusiness. In partnership with her husband, she managed a family-owned cattle farm from 1966 until her appointment to the FCA Board. She served as vice president and secretary of Prairie Hills, Ltd., a feedlot, cow-calf, and row crop operation in Atlantic, Iowa, from 1979 until 2002. She also was president and treasurer of Fredrechsen Farms, Ltd., a family-owned swine and row crop operation in Walnut, Iowa, for more than 20 years.

A long-time beef industry leader, Ms. Pellett has held state and national leadership positions in cattlemen's industry organizations. As a member of the National Cattlemen's Beef Association, she has served as chairman of the Check-Off Division, chairman of the Consumer Marketing Group, and, most recently, as a member of the Cattlemen's Beef Board. She also has been president of the Iowa Beef Industry Council.

She is a partner in Premium Quality Foods, Inc., based in Red Oak, Iowa, which markets branded fresh beef and precooked beef entrees. Previously, she served as president and consumer marketing director for the company.

Ms. Pellett served a six-year term as a member of the Board of Regents for the State of Iowa, which oversees the three state universities, as well as the University of Iowa Hospital and its affiliated clinics. She was also selected as a member of the Governor's Student Aid Commission. She is currently on the Iowa State University (ISU) Foundation Board of Governors and has been a member of the advisory committees for the College of Agriculture and the College of Family and Consumer Sciences. She is past president of the ISU Alumni Association and was awarded the Alumni Medal in 1987. The Pellett family was honored as the "Family of the Year" by ISU in 1997.

Dedicated to the future of agriculture, she has worked with 4-H and the National FFA Organization at the local and state levels, and has served on the Iowa 4-H Foundation Board. She is a founding member of the 4-H/FFA "Sale of Champions" Committee for the Iowa State Fair.

A native of Walnut, Iowa, Ms. Pellett holds a B.S. from Iowa State University at Ames. She and her husband have four children. The Pellett family received the "Friends of Youth Award" in 2000 from the Knights of AkSarBen, a foundation that supports education, youth programs, and rural development in Nebraska and western Iowa. Together with a son and daughter-in-law, Ms. Pellett and her husband operate a fifth-generation family farm in Atlantic, Iowa.

Douglas L. "Doug" Flory

Board Member

Douglas L. "Doug" Flory was appointed to the three-member FCA Board by President George W. Bush on August 1, 2002, for a term that expires on October 13, 2006. He also serves as Chairman of the Board of Directors of the Farm Credit System Insurance Corporation. He was elected to this position in December 2002.

Mr. Flory brings extensive experience in production agriculture, agribusiness, and both commercial bank and Farm Credit lending to his position on the FCA Board. His farming operation includes Bunker Hill Farm, and he is also a 50 percent owner of S & F, L.L.C., a beef, turkey, grain, and hay farm in Virginia's Augusta County.

Before his appointment to the FCA Board, Mr. Flory was a member of the board of directors of AgFirst Farm Credit Bank in Columbia, South Carolina, and a director of Farm Credit of the Virginias, ACA, in Staunton, Virginia. He also served as a member of the Farmer Mac Appraisal Standards Committee.

He was executive vice president of Dominion Bank from 1971 to 1988, and also president, CEO, and director of Dominion Farm Loan Corporation. During his banking career, he chaired the Virginia Bankers Association Committee on Agriculture and was a member of the Executive Committee of the American Bankers Association's agricultural division. From 1989 to 1992, he was executive vice president, chief operating officer, and a member of the board of WLR Foods, Inc., a publicly traded poultry food company (now part of Pilgrim's Pride).

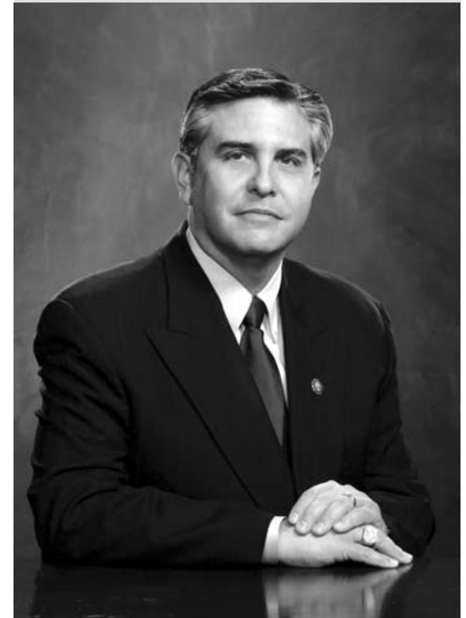
Mr. Flory has served on several governing boards for the Commonwealth of Virginia. He was appointed to the Virginia Agricultural Council, a state advisory board, and the Virginia Agriculture Credit Committee, which he chaired. He also served on the Virginia Agricultural Development Authority, which uses "aggie bonds" to finance Virginia farmers.

Mr. Flory has been an active participant in agriculture industry associations. He has served as president of the Virginia Turkey Association and as president and director of the Rockingham County Fair Association. He also served as a director of the Virginia Poultry Federation, the Virginia Agribusiness Council, the Virginia Beef Cattle Association, and the Virginia Sheep Association.

Mr. Flory, a native of Augusta County, Virginia, attended Bridgewater College in Bridgewater, Virginia, and earned a bachelor's degree from Virginia Polytechnic Institute and State University in Blacksburg. He did graduate work at James Madison University and is a graduate of the Maryland–Virginia School of Bank Management at the University of Virginia. He and his wife, Avery, are the parents of two daughters and a son.

Michael M. Reyna

Board Member



Michael M. Reyna serves as a member of the FCA Board, having completed his term as Chairman and CEO on May 21, 2004.[1] Mr. Reyna was appointed to the three-member FCA Board by then-President William J. Clinton and confirmed by the United States Senate on October 22, 1998. His term expired May 21, 2004. He also serves as a member of the Board of Directors of the Farm Credit System Insurance Corporation.

Before his appointment to the FCA Board, Mr. Reyna served as director of the U.S. Department of Agriculture's (USDA) Rural Development (formerly known as Farmers Home Administration) in California from November 1993 to October 1998. In this capacity, he was responsible for growing and managing a diversified portfolio of housing, business, and infrastructure loans totaling more than $2.6 billion. He implemented a number of significant initiatives in California, including the Northwest Economic Adjustment Initiative, the Rural Empowerment Zone-Enterprise Community program, the AmeriCorps program, and several Reinventing Government initiatives.

Prior to his Federal service, Mr. Reyna served at the state level for 11 years as a principal advisor to the California State Legislature, working on financial service industry regulation and a wide range of issues, including housing, economic development, local government finance, and political reform. He was an appointed member of several local commissions, including the Sacramento City Planning Commission, which he served as chairman in 1993. In addition, he was a founding board member of Meadowview Community Action, a local nonprofit agency. While attending graduate school in Texas, Mr. Reyna served as a private consultant to Governor Bill Clements' long-range strategic planning effort, known as the Texas 2000 Project. In this capacity, he developed and implemented a computer-based simulation model that estimated employment and population trends in Texas through the year 2000.

Mr. Reyna is the recipient of the LBJ School of Public Affairs Alumni Association's Distinguished Public Service Award for 2003. In 1998 and 1999, he received awards from the California Rural Builders' Council, the Rural California Housing Corporation, the California Coalition for Rural Housing, and the Valley Small Business Corporation in recognition of his leadership and commitment to rural America. In 1996, Mr. Reyna received Vice President Al Gore's Hammer Award for helping to reinvent the USDA Rural Development Business and Industry Loan Guarantee Program. The California State Senate and Assembly also acknowledged his many contributions while on staff.

Mr. Reyna, a native of Texas, holds a bachelor's degree in business administration from the University of Texas at Austin and a master's degree in public policy from the LBJ School of Public Affairs at the University of Texas. He and his wife, Karen, have two sons.

1. Mr. Reyna continued to serve as a Member of the FCA Board until December 1, 2004, when he was succeeded by Dallas P. Tonsager.

FCA—The Agency

The 287 full- and part-time employees[2] of the Farm Credit Administration work together to ensure that the Farm Credit System remains a dependable source of credit for agriculture and rural America. In the summer, they are supported in FCA's offices by interns, who gain valuable government and business experience.

The following paragraphs explain the role of each of the Agency's offices.

The **FCA Board** approves the policies, regulations, charters, and enforcement activities that ensure a strong Farm Credit System. The Board also provides for the examination and supervision of the FCS, including Farmer Mac, and oversees the FCS Building Association's (FCSBA) activities.

The **Secretary to the Board** ensures that the FCA Board complies with statutory, regulatory, and internal operation procedures requirements and is the Parliamentarian to the FCA Board and the Farm Credit System Insurance Corporation Board of Directors. Other functional responsibilities include *Federal Register* authorizing, certifying, and liaison officer duties; creation and maintenance of the Agency's public rulemaking files; issuance and maintenance of the *FCA Handbook*; direct data entry and Agency submission of the Unified Agenda of Federal Regulatory and Deregulatory Actions.

The **Office of the Chief Executive Officer** (OCEO) enforces the rules, regulations, and orders of the FCA Board, is responsible for the general management of Agency operating units, and has broad responsibility for planning, organizing, directing, coordinating, and controlling the Agency's day-to-day operations and providing liaison between the FCA Board and professional staff on policy matters. The office supervises the development and implementation of operating plans and budgets to ensure streamlined and efficient operations. The OCEO is composed of the CEO, the Chief of Staff, the Executive Director for Planning and Projects, and the Equal Employment Opportunity Director and Ombudsman.

The **Office of Congressional and Legislative Affairs** directs all Agency congressional relations activities, informs and advises the FCA Board and senior management of developments and issues affecting the Agency and the Farm Credit System, drafts testimony, and coordinates all Agency communication with Congress. The office conducts briefings and provides information and educational materials to Members of Congress and their staffs, and monitors and analyzes information obtained from multiple sources.

The **Office of Communications and Public Affairs** manages the production of all information disseminated to the Agency's various audiences, including FCS institutions

2. As of September 30, 2004.

and borrowers, Congress, the media, other Federal agencies, employees, and the public. It provides information to external audiences through news releases, information brochures and fact sheets, the annual *FCA Performance and Accountability Report*, the *FCA Annual Report on the Farm Credit System*, and other publications. The office manages media relations regarding Agency activities and the content of FCA's Web site, and provides graphic design and duplicating services to the Agency. OCPA also coordinates special meetings, briefings for international visitors, field hearings, and other events and responds to inquiries from the public.

The **Office of Examination** supervises FCS institutions through examination, comprehensive oversight programs, and regulatory standards that are designed to ensure safe and sound operations. This allows the System to accomplish its congressional mandate as a government-sponsored enterprise (GSE) for agriculture and rural America. The office ensures that FCS institutions comply with applicable laws and regulations, directs a program of examination policy formulation, and manages the Agency's enforcement activities.

The **Office of the General Counsel** provides the FCA Board and staff with legal counsel, as well as guidance on general corporate, personnel, ethics, and administrative matters. The office supports the Agency's development and promulgation of regulations, civil litigation, enforcement of applicable laws and regulations, and implementation of conservatorships and receiverships. The office also handles Freedom of Information Act requests and matters pertaining to the Government in the Sunshine Act and the Privacy Act.

The **Office of the Inspector General** provides independent and objective oversight of Agency programs and operations through audits, inspections, investigations, and the review of proposed legislation and regulations.

The **Office of Policy and Analysis** manages all regulation and policy development activities that ensure the safety and soundness of the FCS and supports the System's mission as a dependable source of credit and related services for agriculture and rural America. The office monitors economic trends and emerging risk factors that affect the System and its customers, and collects and analyzes data from FCS institutions. The office also manages the chartering and other corporate approvals for System institutions, as well as other statutory, regulatory, and funding approval activities on behalf of the FCA Board.

The **Office of the Chief Administrative Officer** oversees and administers the Agency's Human Capital Program. It also provides administrative services, including payroll, training, contracting, procurement, mail, supply, transportation services, and property management.

The **Office of the Chief Information Officer** oversees all activities related to planning, managing, and administering FCA's information technology (IT). The office ensures adequate security and integrity of Agency IT. It provides office automation software; database administration; systems development; customer assistance; and network, videoconferencing, Web, and e-business services, as well as records management advice and services and library services.

The **Office of the Chief Financial Officer** provides financial services to the Agency, including preparation of the budget, financial reporting, and financial systems operations.

The **Office of Secondary Market Oversight** provides for the examination, regulation, and supervision of the Federal Agricultural Mortgage Corporation's activities to ensure its safety and soundness and accomplishment of its public policy purpose as authorized by Congress. It also ensures that Farmer Mac complies with applicable laws and regulations and manages the Agency's enforcement activities with respect to Farmer Mac.

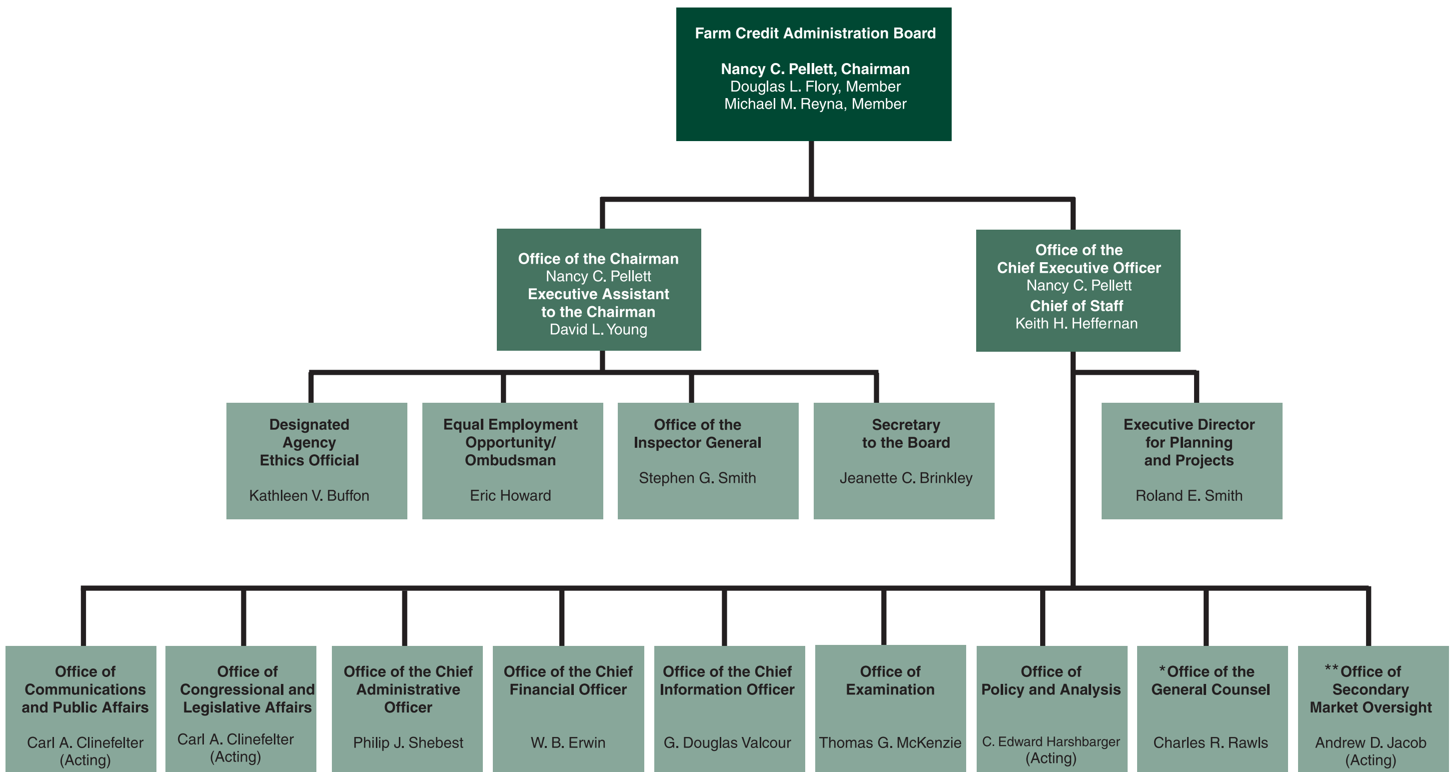
The **Equal Employment Opportunity** (EEO) **Program** directs the Agency's efforts to achieve and manage a diverse workforce and encourages awareness of and respect for diversity in the workplace. The program works to prevent employment discrimination, handles employee discrimination complaints, and sponsors training and seminars on EEO issues.

The **Ombudsman** is a neutral and confidential resource for institutions of the Farm Credit System and other parties relative to inquiries or complaints they may have with respect to actions of the Agency; acts to facilitate the resolution of problems or complaints in a fair, impartial, and timely manner; and provides recommendations to the Chairman and CEO to improve Agency policies, procedures, and practices based on investigation or analysis of inquiries and complaints.

The **Designated Agency Ethics Official** (DAEO) administers the provisions of Title I of the Ethics in Government Act of 1978, as modified by the Ethics Reform Act of 1989, within FCA. The DAEO coordinates and manages FCA's ethics program and serves as liaison to the U.S. Office of Government Ethics with regard to all aspects of the program. The responsibilities of the position include reviewing financial disclosure reports of FCA staff and prospective presidential appointees to the FCA Board, conducting FCA's ethics training, counseling staff on ethics standards and postemployment conflicts of interest, and assisting managers and supervisors in understanding and implementing Agency ethics programs.

Figure 1 shows FCA's organizational structure as of September 30, 2004.

Figure 1
Farm Credit Administration Organizational Structure
As of September 30, 2004



*Maintains a confidential advisory relationship with each of the Board members.
** Reports to the Board for policy and to the CEO for administration.

Agency Officials

Jeanette C. Brinkley is Secretary to the FCA Board. She joined FCA in November 1982 as a secretary in the Office of Administration. During her tenure with FCA, Ms. Brinkley has worked in the Office of Examination and Supervision, the Office of Congressional and Public Affairs, and the Office of the Chief Operating Officer. In 1995, she began working for the Office of the Board as the administrative specialist to the Secretary to the FCA Board.

Kathleen V. Buffon is the Designated Agency Ethics Official. She was first appointed to the position in 1992 when she came to FCA as Associate General Counsel, a position she continues to hold. Before joining FCA's Office of General Counsel, she served as Assistant Director for Credit Practices at the Federal Trade Commission. Following her graduation from law school, she clerked for the Honorable Henry H. Kennedy, Jr., an Associate Judge of the Superior Court of the District of Columbia.

Carl A. Clinefelter is Acting Director of the Office of Communications and Public Affairs and the Office of Congressional and Legislative Affairs.[3] Before assuming this position on September 1, 2004, he was Director of the Office of the Ombudsman. He also served as Director of the Office of Secondary Market from December 20, 1998, until March 2, 2003. Since joining FCA in October 1980, he has served as a regional supervisory officer in the Office of Supervision, an Associate Regional Director in the Office of Examination and Supervision, Acting Director of the Office of Special Supervision and Corporate Affairs, and Assistant Director of the Office of Policy and Analysis. Concurrent with the latter position, he served as executive assistant for FCA Board Member Doyle L. Cook. Before joining FCA, he was assistant vice president at the Federal Intermediate Credit Bank of New Orleans.

W. B. Erwin is the Chief Financial Officer. Before joining FCA in June 2000, he served as Assistant Chief Financial Officer for Systems for the Department of Housing and Urban Development. From 1989 to 1997, he was Director of the Office of Finance for the U.S. Patent and Trademarks Office. He has worked for the Navy, the Air Force, the Treasury Department, the U.S. Government Printing Office, and the Social Security Administration. His private industry experience comes from his tenure at Caterpillar and Cummins. He is a certified public accountant, certified management accountant, and certified government financial manager.

3. Hal C. DeCell III served as Director of the Office of Congressional and Legislative Affairs and Acting Director of the Office of Communications and Public Affairs until August 31, 2004.

C. Edward Harshbarger[4] is Acting Director of the Office of Policy and Analysis. Before being named to this position on September 1, 2004, he was Director of the Risk Analysis Division in the Office of Policy and Analysis. During his tenure at FCA, he has held several key positions managing various planning and regulatory programs. He was instrumental in developing and implementing the Agency's strategic planning activities. Before joining FCA in 1983, he was research manager at Farmbank Services, a service organization of the Farm Credit System. He has also served as an assistant vice president and economist at the Federal Reserve Bank of Kansas City and an assistant professor of agricultural economics at the University of Missouri.

Keith H. Heffernan is the Chief of Staff. Before joining FCA in July 2004, he served as Chief of Staff for the Under Secretary for Rural Development at the U.S. Department of Agriculture. His previous experience includes serving as assistant director of the Center for Agricultural and Rural Development at Iowa State University. From 1983 to 1989, he served the State of Iowa as deputy director of the Iowa Development Commission, as administrative assistant to Governor Terry Brandstad, and as director of the Department of Commerce. He also served as executive director of the Iowa Corn Growers Association, which represents the state's 100,000 corn producers, from 1977 to 1983.

Eric Howard[5] is the Equal Employment Opportunity Director and the Ombudsman. He joined FCA in 1986 as an examiner in FCA's Oklahoma City field office. In 1991, he became a policy analyst for the Policy and Risk Analysis Division in the Office of Examination in McLean, Virginia. He became a senior policy analyst for the Regulation and Policy Division of the Office of Policy and Analysis in 1997.

Andrew D. Jacob[6] is Acting Director of the Office of Secondary Market Oversight. Before assuming this position on August 11, 2004, he served as the assistant director of the Office of Policy and Analysis. He has held several positions in FCA, beginning as a credit examiner in the Sacramento field office in 1986. In 1988, he transferred to McLean as an information systems examiner and then became an FCA examiner in the Office of Examination in 1990. He transferred to the Office of Policy and Analysis in 1997, where he served as a senior policy analyst and a senior financial analyst before being named assistant director in 1999.

4. Michael V. Dunn served as Director of the Office of Policy and Analysis until August 31, 2004.
5. Eric Howard assumed the responsibilities of Ombudsman on August 11, 2004.
6. Andrew D. Jacob was named Director of the Office of Secondary Market Oversight on December10, 2004.

Thomas G. McKenzie is Chief Examiner and Director of the Office of Examination.[7] He joined the Agency in 1979 and has served as Director of the Office of Secondary Market Oversight and Director of the Office of Policy and Analysis; he has also held regional and division director positions in the Office of Examination and the former Office of Supervision. He headed the Agency's regional offices of examination in Denver and Atlanta, where he oversaw the field offices in Albany, New York; Atlanta; Dallas; Denver; and Sacramento, California. He began his Federal government career with FCA as a management specialist and advisor for the Agricultural Bank of Saudi Arabia in Riyadh. Before joining FCA, he was a regional manager for a Federal Land Bank; a manager and CEO of a Federal Land Bank Association; and a financial analyst for a Bank for Cooperatives, where he began his career in agricultural credit in 1971.

Charles R. Rawls is the FCA General Counsel. Before joining FCA in March 2003, he was general counsel and vice president for legal, tax, and accounting at the National Council of Farmer Cooperatives. During the consideration of the 2002 farm bill, he served as the General Counsel of the Senate Committee on Agriculture, Nutrition, and Forestry. From 1998 until 2001, he was General Counsel for the United States Department of Agriculture. Before that he was Chief of Staff to the Deputy Secretary of Agriculture from 1993 to 1998. From 1988 to 1993 he was Legislative Director and then Administrative Assistant to Representative Martin Lancaster (D–North Carolina). From 1985 to 1988 he was Associate General Counsel of the House Committee on Agriculture. He was Counsel to the House Agriculture Subcommittee on Forests, Family Farms, and Energy from 1983 until 1985.

Philip J. Shebest is the Chief Administrative Officer. He joined FCA in 1990 as a senior attorney in the Office of General Counsel. He became the Director of the Human and Administrative Resources Division in 1996 and in 2000 was selected as Chief Administrative Officer. Before joining FCA, he was a senior attorney-advisor in the Chief Counsel's Office of the Drug Enforcement Administration from 1985 until 1990. From 1981 through 1984, he held the rank of lieutenant in the Judge Advocate General Corps of the U.S. Navy and was stationed in Washington, D.C., as an appellate litigation attorney.

Roland E. Smith is Executive Director for Planning and Projects. Before being named to this position on August 11, 2004, he served as Chief Examiner and Director of the Office of Examination. He joined FCA in 1979 as an examiner in the St. Louis field office. In 1984, he was promoted to Associate Regional Director. He also managed FCA's Oklahoma City field office and later the Denver field office before he became FCA's Chief Examiner in October 1996. He began his career with the Farm Credit System in 1974 as a loan officer for the Production Credit Association in Greenville, North Carolina. He later served as a loan officer and credit reviewer for the Farm Credit Banks of Columbia, South Carolina.

7. Thomas G. McKenzie served as Director of the Office of Secondary Market Oversight until he was named Chief Examiner and Director of the Office of Examination on August 11, 2004.

Stephen G. Smith became the Inspector General in January 2001. He joined FCA in 1981 as a technical specialist. He became an examiner in 1984 and later served as staff assistant for the Chief Examiner. In 1989, he was named associate regional director for the Agency's Albany, New York, field office. He later served as senior staff director for the Chief Examiner, and was then named director of the Technical and Operations Division. In 1993, he assumed new responsibilities as director of the Information Resources Division. He was named Chief Information Officer in 1996, directing all technology and information operations for FCA. Before joining the Agency, he worked at the North Central Jersey Farm Credit Associations.

G. Douglas Valcour is the Chief Information Officer. He joined FCA in 1988 as a computer specialist in the Office of Resources Management. In 1990, he became Chief of the Systems Development Branch, and he was named Associate Director of the Information Resources Division and team leader of the Technology Team in 1997. Before joining FCA, he was a computer specialist for the U.S. Department of Energy from 1986 until 1988. From 1983 to 1986, he was a computer programmer and analyst for the Veterans Administration.

David L. Young is Executive Assistant to Chairman Nancy C. Pellett. He has served in this capacity since Chairman Pellett joined the Agency in November 2002. A commissioned FCA examiner, Mr. Young joined the Agency in 1986, and served most recently as an examiner in the Bloomington, Minnesota, field office. He was Chairman of FCA's EEO and Diversity Committee, and represented the Agency on the Minnesota Federal Executive Board's Diversity Council. He is the recipient of the Federal Executive Board's "Civil Servant of the Year" Award for his contributions to government and the community. Before joining FCA, Mr. Young worked for the U.S. General Accounting Office (now the Government Accountability Office) for 12 years. At GAO's Chicago Field Office he headed evaluations of Federal natural resource programs, and in the Honolulu Field Office he led evaluations of U.S. banking, cooperative, and military programs worldwide. Mr. Young served in the U.S. Army Reserves for 28 years and retired as a Lieutenant Colonel.

Farm Credit System—An Overview of Events and Conditions

FCS Function and Structure

The Farm Credit System is a network of borrower-owned cooperative financial institutions and related service organizations. It is the largest single agricultural lender in the country and serves all 50 states and the Commonwealth of Puerto Rico. Created by Congress in 1916 to provide American agriculture with a dependable source of credit, the FCS is the oldest of the five government-sponsored enterprises (GSEs).

FCS institutions provide credit and financially related services to farmers, ranchers, producers or harvesters of aquatic products, and farmer-owned cooperatives. They also make loans for agricultural processing and marketing activities; rural housing; certain farm-related businesses; agricultural and aquatic cooperatives; rural utilities; and foreign and domestic entities in connection with international agricultural trade. The System raises its loan funds by selling securities in the national and international money markets, subject to approval by the Farm Credit Administration. These securities are not guaranteed by the U.S. government. The funds are channeled as loans to rural America through the FCS lending institutions.

As of September 30, 2004, the System was composed of 102 banks and associations. Five Farm Credit banks provide loan funds to 84 Agricultural Credit Association (ACA) parent organizations,[8] two ACAs without subsidiaries, and 11 Federal Land Credit Associations (FLCAs). ACAs make short-, intermediate-, and long-term loans; FLCAs make only long-term loans; and Production Credit Associations (PCAs), which are subsidiaries of ACAs, make only short- and intermediate-term loans.

One of the five banks is an Agricultural Credit Bank (ACB), which has a nationwide charter to make loans to agricultural and aquatic cooperatives and rural utilities, as well as to other persons or organizations that have transactions with or are owned by such cooperatives. The ACB finances U.S. agricultural exports and imports and provides international banking services for farmer-owned cooperatives. In addition to making loans to cooperatives, the ACB provides loan funds to five ACA parent organizations, which serve New York, New Jersey, Connecticut, Rhode Island, Maine, Massachusetts, New Hampshire, Vermont, Alaska, Oregon, Washington, Montana, and Idaho.

In addition to the banks and associations described above, FCA examines and regulates the following three entities:

The **Federal Farm Credit Banks Funding Corporation** (Funding Corporation), which markets debt securities that the banks sell to raise loan funds. The Funding Corporation is owned by the System banks.

The **Farm Credit System Financial Assistance Corporation**,[9] chartered in 1988, which provided needed capital to the System through the sale of $1.3 billion in 15-year bonds to the capital markets and the purchase of preferred stock. This stock was issued by certain System institutions that received financial assistance as authorized by the Farm Credit System Assistance Board.[10]

The **Federal Agricultural Mortgage Corporation**,[11] which provides a secondary market arrangement for agricultural real estate and rural housing mortgage loans and provides greater liquidity and

8. The ACA is the parent company with two wholly owned subsidiaries, a Production Credit Association and a Federal Land Credit Association. Although legally separated, the ACA, the PCA, and the FLCA operate an integrated lending business, with loans made through the subsidiaries appropriate to the authority of each subsidiary. The ACA, the PCA, and the FLCA are jointly and severally liable on the full amount of the indebtedness to the bank under the bank's General Financing Agreement. In addition, the three associations agree to guarantee each other's debts and obligations, pledge their respective assets as security for the guarantee, and share each other's capital. The three institutions have a common board and management and a common set of shareholders. Under the Farm Credit Act, the FLCA is exempt from Federal income taxes.
9. The Farm Credit System Financial Assistance Corporation (FAC) will continue in existence until no later than two years following the maturity and full payment of its outstanding debt securities, which mature, at the latest, in June 2005. The board of directors of the FAC is the same as the board of directors of the Funding Corporation.
10. The Farm Credit System Assistance Board was created by the Agricultural Credit Act of 1987 to provide assistance to financially troubled FCS banks, protect the stock of System borrowers, restore FCS banks to economic viability, and preserve their ability to provide credit at reasonable and competitive rates. The Farm Credit System Assistance Board terminated on December 31, 1992.
11. Farmer Mac is established in law as a part of the Farm Credit System. However, Farmer Mac has no liability for the debt of any other System institution, and the other System institutions have no liability for Farmer Mac debt. Farmer Mac is organized as an investor-owned corporation, not a member-owned cooperative. Investors in voting stock may include commercial banks, insurance companies, other financial organizations, and FCS institutions. Nonvoting stock may be owned by any investor. Farmer Mac is regulated by the Farm Credit Administration through the Director of the Office of Secondary Market Oversight, who reports to the FCA Board on matters of policy.

lending capacity to agricultural lenders. Under the Farmer Mac I program, Farmer Mac guarantees prompt payment of principal and interest on securities representing interests in, or obligations backed by, mortgage loans secured by first liens on agricultural real estate or rural housing; it also purchases or commits to purchase qualified loans or securities backed by qualified loans directly from lenders. Under the Farmer Mac II program, it guarantees securities backed by the "guaranteed portions" of farm ownership and operating loans, rural business and community development loans, and certain other loans guaranteed by the U.S. Department of Agriculture.

FCA also examines and regulates the following five service corporations organized under Section 4.25 of the Farm Credit Act:[12]

AgVantis, Inc., which provides technology-related and other support services to the associations affiliated with U.S. AgBank, FCB. AgVantis, which was chartered by FCA on August 3, 2001, is owned by the bank and its affiliated associations.

Farm Credit Finance Corporation of Puerto Rico, which uses tax incentives offered to investors to provide low-interest funding (other than that from the Funding Corporation) to the Puerto Rico Farm Credit, ACA.

Farm Credit Leasing Services Corporation (Leasing Corporation), which provides equipment leasing services to eligible borrowers, including agricultural producers, cooperatives, and rural utilities. The Leasing Corporation is owned by CoBank, ACB.

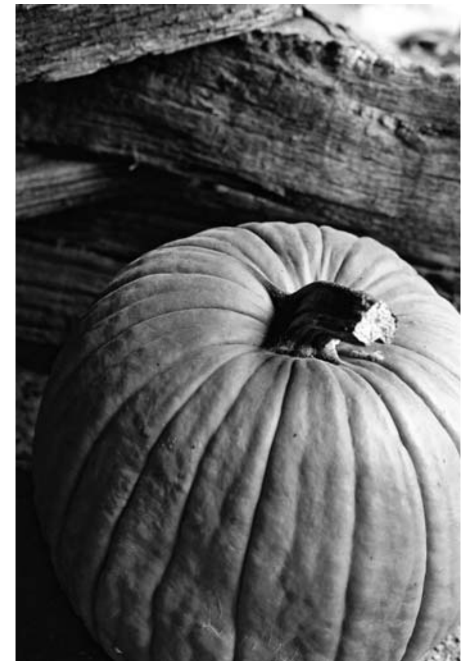
Farm Credit Financial Partners, Inc., which provides support services to CoBank, ACB and its five affiliated associations, five associations affiliated with U.S. AgBank, FCB, and one association affiliated with AgriBank, FCB.

FCS Building Association, which acquires, manages, and maintains facilities to house FCA's headquarters and field office staff. The FCSBA was formed in 1981 and is owned by the FCS banks. The FCA Board oversees the FCSBA's activities on behalf of its owners.

When Congress established the Farm Credit System as a government-sponsored enterprise its purpose was to provide a permanent, reliable source of credit and related services to agriculture and aquatic producers, their cooperatives, and related businesses in rural America. Congress intended the farmer-owned cooperative FCS to improve the income and well-being of American farmers and ranchers. It further encouraged farmer- and rancher-borrower participation in the management, control, and ownership of these cooperative institutions to help them remain focused on serving their members' needs.

The System meets a broad public need by preserving liquidity and competition in rural credit markets in both good and bad economic times. The accomplishment of this public goal benefits all eligible borrowers, including young, beginning, small, family, minority, female, and socially disadvantaged farmers, as well as rural home purchasers.

FCA's regulations, policy statements, examinations, chartering activities, and other regulatory activities (discussed in later chapters of this report) support and facilitate the accomplishment of the System's mission by ensuring that FCS



12. Section 4.25 of the Farm Credit Act provides that one or more FCS banks or associations may organize a service corporation to perform functions and services on their behalf. These federally chartered service corporations are prohibited from extending credit or providing insurance services.

institutions operate in a safe and sound manner without undue risk to taxpayers, investors in System securities, or its borrower-stockholders.

The sections in this chapter first assess the System's financial strength and then its service to rural America. Our discussion relies on commonly used measures, including trends in volume by a variety of loan types, volume of funding for non-System rural lenders and participations with other lenders, and the System's share in the marketplace. Discussion in the next chapter also covers lending activity and programs that benefit young, beginning, and small farmers and ranchers and the use of government guarantee programs in supporting loans to farmers who are unable to meet normal underwriting requirements.

Financial Condition of the FCS[13]

Farm Credit System loan growth was moderate for the year ending September 30, 2004. (See "Borrowers Served" on page 19.) Nonaccrual loans decreased significantly over the 12-month period, and asset quality remained high. Interest rates remained near 45-year lows throughout the past year, ensuring low interest expense but also contributing to reduced net interest margins. Continued high levels of government payments to the agricultural sector supplemented the incomes of borrowers. (See page 41 for a discussion of Challenges Facing Agriculture, the Rural Economy, and the FCS.)

Asset Quality

Loan volume grew moderately, and loan quality remained high for the year ending September 30, 2004. Gross loans increased by 3.9 percent to $94.9 billion. Nonperforming loans[14] dropped substantially to 0.88 percent of gross loans. Nonaccrual loans were 0.74 percent of gross loans, compared with 1.17 percent in September 2003 (see Figure 2). The allowance for loan losses as a percentage of gross loans dropped to 2.1 percent. At September 30, 2004, the allowance for loan losses represented 242 percent of nonperforming loans, compared with 171 percent a year earlier. System institutions are reviewing the methodology used to determine allowances for loan losses and have stated that they expect to make significant reductions in their allowances in the fourth quarter of 2004.[15] One association completed its study in the second quarter of 2004, recording a $27 million negative provision for loan losses. Delinquencies (accrual loans 90 or more days past due) remained minimal.

Earnings

Favorable credit quality enabled the System to achieve a record $1.4 billion in earnings for the nine months ending September 30, 2004 (see Figure 3). Provisions for loan losses for the first nine months of 2004 were $11 million, down $95 million from the same period in 2003. The Systemwide net interest margin declined to 2.52 percent as of September 30, 2004, from 2.62 percent a year earlier. Noninterest expense during the first nine months of 2004 increased by $68 million (7.5 percent) to $973 million. Noninterest income for the first nine months of 2004 was $272 million, compared with $291 million for the same period last year.

Capital[16]

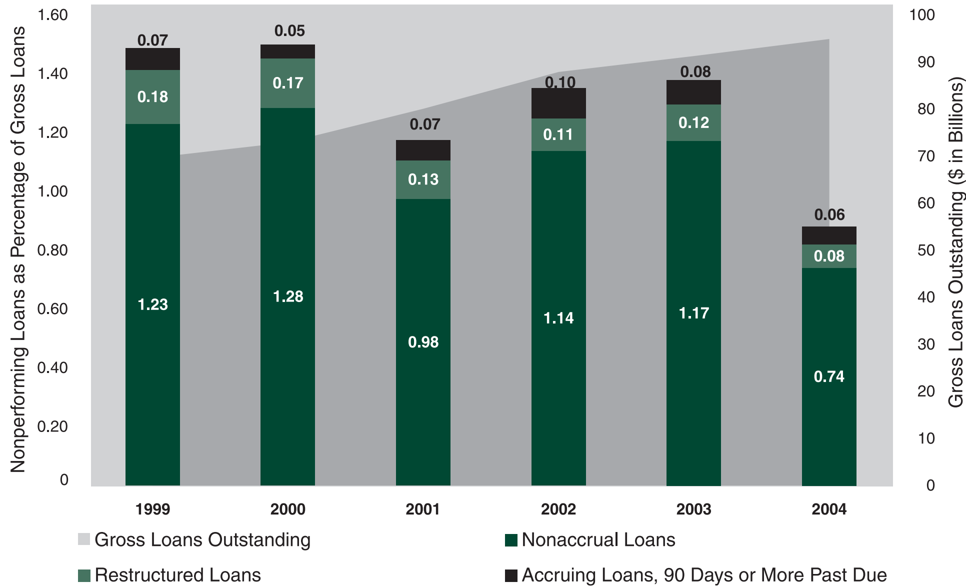
The System continues to build capital through increased loan volume and earnings. Total capital increased 10.9 percent to $20.2 billion, which represented

13. The information presented in this section includes that pertaining to all Farm Credit Banks and the Agricultural Credit Bank and their affiliated associations. The FCS institutions provided the data used in the overall FCS analysis to the FCA or to the Federal Farm Credit Banks Funding Corporation. The analysis in this report is based on publicly available information and, except where noted, is based on the 12-month period ending September 30, 2004. See Tables 2 and 3 on pages 24 and 25, respectively, for System measures of financial condition.
14. Nonperforming loans consist of nonaccrual loans, accruing restructured loans, and accrual loans 90 or more days past due.
15. In February 2005, the FCS reported a one-time reversal of the allowance for loan losses of $1.167 billion, net of a related $95 million tax impact, in connection with the completion of studies to refine the System's methodologies for determining the allowance for loan losses.
16. In addition to accumulated surplus and borrower stock, total capital includes perpetual preferred stock, restricted capital, and accumulated other comprehensive income. It does not include mandatorily redeemable term preferred stock or protected capital. Restricted capital ($2.1 billion at September 30, 2004) represents the total assets under the control of the Farm Credit System Insurance Corporation, including assets that have been identified for estimated insurance obligations and the Farm Credit Insurance Fund balance. Accumulated Other Comprehensive Income (negative $227 million at September 30, 2004) for the System consisted mostly of minimum pension liability adjustments and unrealized holding losses on available-for-sale securities. One System bank had outstanding $225 million of Mandatorily Redeemable Term Preferred Stock. Such stock is not included in "total capital," though it qualifies for certain regulatory capital purposes. Protected capital ($24 million at September 30, 2004) consists of borrower stock, participation certificates, and allocated equities that were outstanding as of January 6, 1988, or were issued or allocated before October 8, 1988. Protection of certain borrower capital is provided under the Farm Credit Act, which requires FCS institutions, when retiring protected borrower capital, to retire such capital at par or stated value regardless of its book value.

Figure 2

Farm Credit System Nonperforming Loans Drop Sharply

As of September 30

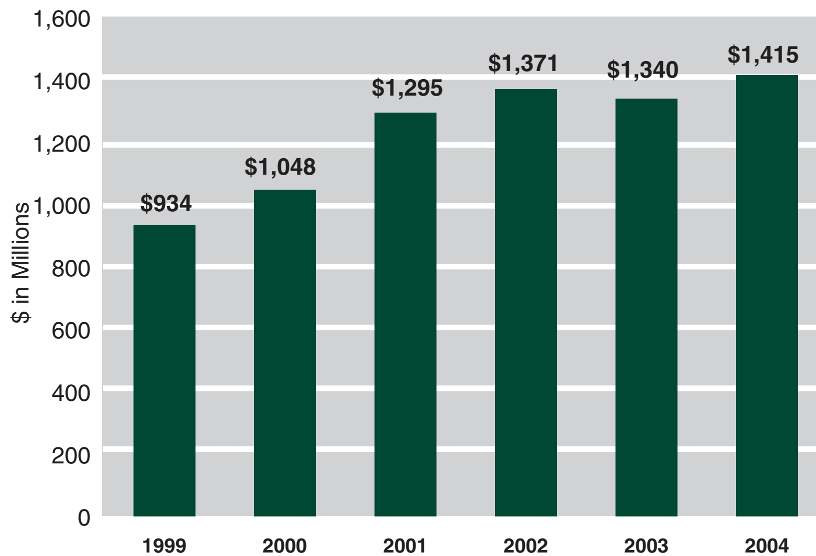


Source: Federal Farm Credit Banks Funding Corporation, Quarterly Information Statements, Third Quarter.

Figure 3

Farm Credit System Reports Record Net Income

Nine Months Ending September 30



Source: Federal Farm Credit Banks Funding Corporation, Quarterly Information Statements, Third Quarter.

16.6 percent of total assets (see Figure 4). Accumulated surplus represents more than 13.1 percent of System assets and 78.9 percent of total capital. For the 12 months ending September 30, 2004, preferred stock increased $631 million to $931 million, representing 4.6 percent of total capital.

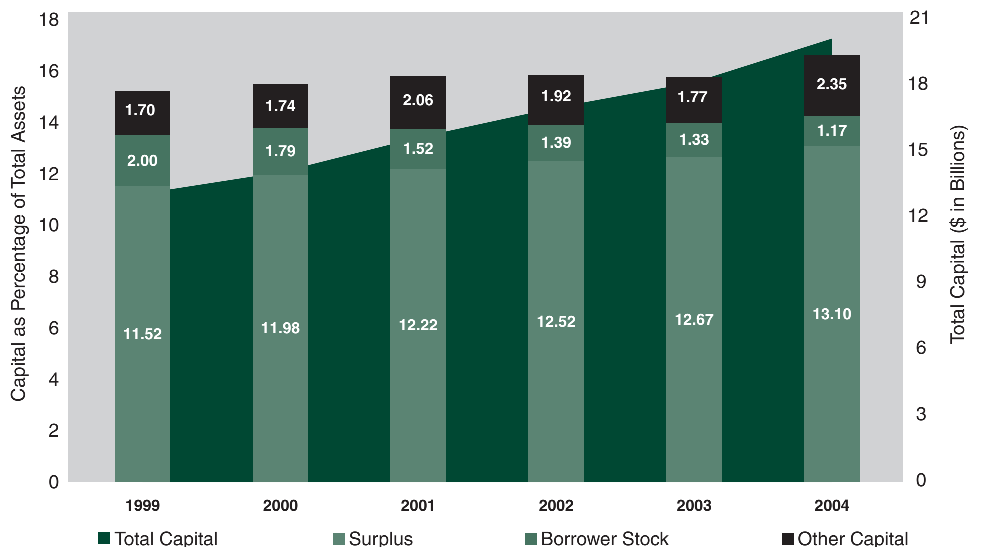
Permanent capital ratios (PCRs) at System associations ranged from a low of 11.8 percent to a high of 31.0 percent—all well above the 7 percent minimum regulatory requirement. For System banks, PCRs ranged from 15.6 percent to 26.6 percent. All institutions also exceeded their minimum regulatory requirement core surplus ratio (3.5 percent) at September 30, 2004.

Funding

The System funds its loans with a combination of consolidated Systemwide debt and capital. The par value of outstanding Systemwide debt increased by $3.9 billion (4.2 percent), while gross loans outstanding increased by $3.6 billion (3.9 percent). The incremental debt of $300 million and the increase in capital of $2.0 billion were used to fund added investments for liquidity.[17]

Because of lower interest rates over the past few years, the System was able to retire and reissue substantial portions of its callable debt, resulting in high levels of debt securities issuance during 2001 and early 2002. Since then, the System has gradually extended the maturity date of its

Figure 4
Farm Credit System Capital Continues to Increase
As of September 30



Source: Federal Farm Credit Banks Funding Corporation, Quarterly Information Statements, Third Quarter.

17. System banks, as part of an ongoing effort to ensure their collective ability to meet their obligations under their mutual agreements concerning joint and several liability on Systemwide debt, have adopted a Common Liquidity Standard (Standard). This Standard requires each bank to maintain a minimum of 90 days of liquidity, assuming no access to the capital markets.

debt. The longer debt maturities, reduced volume of callable debt, and moderating loan demand have combined to reduce the amount of debt issued. For the 12 months ending September 30, 2004, the System issued $334 billion in insured debt securities,[18] compared with $332 billion for the previous 12 months. By comparison, the System issued $517 billion of insured debt in the 12 months ending September 30, 2001. The System's weighted average remaining maturity for all outstanding insured debt decreased slightly to 2.2 years at September 30, 2004, compared with 2.3 years at September 30, 2003, and 1.8 years at September 30, 2001. The weighted average yield for the insured debt securities increased from 2.7 percent at September 30, 2003, to 2.9 percent at September 30, 2004.

Borrowers Served

The System fulfills its overall mission by using its authority to lend to agriculture and rural America. Through changes in law since the System's original authorization in 1916, System lending authorities have evolved to include providing the following:

- long-term agricultural real estate loans, including rural home loans;
- short- and intermediate-term agricultural loans;
- loans to producers and harvesters of aquatic products;
- loans to certain farmer-owned agricultural processing facilities and farm-related businesses;
- loans to farmer-owned agricultural cooperatives;
- loans that finance agricultural exports and imports; and
- loans for rural utilities.

Nationwide, the System had $94.9 billion in gross loans outstanding as of September 30, 2004 (see Table 1, page 20). Agricultural producers represented by far the largest borrower group with $76.9 billion, or 81.1 percent of the total dollar amount of loans outstanding.[19] As required by law, all borrowers are also stockholder-owners of System institutions. The System had nearly 712,000 loans and approximately 445,000 stockholders. Approximately 83 percent of the stockholders are farmers with voting stock. On the basis of the 2002 Census of Agriculture's expanded count of 3.1 million farm operators (multiple operators per farm), about 12.0 percent of all U.S. farmers are stockholders of System institutions.

More than half of the System's total loan volume outstanding (54.6 percent) was in long-term real estate loans, 26.4 percent in short- and intermediate-term loans to agricultural producers, and 16.0 percent in loans to cooperatives. International loans (export financing) represented 3.0 percent of the System's loan portfolio. As of December 31, 2003, rural home loans made up about 2.4 percent of total loans. (These are part of long-term real estate loans in Table 1).[20] Loans to finance rural utilities (included in cooperative loans) were 7.8 percent of overall loan volume; this segment had increased roughly 50 percent over the previous five years. Lease receivables (included in both the domestic cooperatives and the short- and intermediate-term categories) had dipped and accounted for less than 2.0 percent of the overall System portfolio as of December 31, 2003.

18. Payment of principal and interest on Systemwide debt securities is insured by the Farm Credit System Insurance Corporation's Farm Credit Insurance Fund to the extent provided in the Farm Credit Act. Some FCS debt—$928 million at September 30, 2004—was issued by individual banks of the FCS. These individual banks are solely liable for this uninsured debt.
19. Some of this total consists of loans to rural homeowners and leases.
20. More detailed loan category breakouts are reported by the Federal Farm Credit Banks Funding Corporation at calendar year-end for agricultural and cooperative lending; this includes rural home lending, domestic cooperatives, rural utilities, lease receivables, farm-related businesses, other financing institutions, and other.

Table 1

Farm Credit System Gross Loans Outstanding, 1999–2004

As of September 30

Dollars in Millions

Loan Category	1999	2000	2001	2002	2003	2004	Percentage Change from 1999
Long-Term Real Estate[1]	$34,218	$35,549	$39,722	$44,782	$48,852	$51,849	51.5
Short- and Intermediate-Term[2]	18,616	18,917	21,397	23,328	23,990	25,072	34.7
Domestic Cooperatives[3]	14,549	15,908	16,298	16,774	15,595	15,157	4.2
International	2,274	2,583	2,679	3,033	2,865	2,821	24.1
Total	**$69,657**	**$72,957**	**$80,096**	**$87,917**	**$91,302**	**$94,899**	**36.2**

1. Includes rural home loans and various loans classified as "other."
2. Includes a portion of loans classified as "lease receivable" and various loans classified as "other."
3. Includes loans to rural utilities, rural water and waste facilities, and a portion of loans classified as "lease receivable."

Source: Federal Farm Credit Banks Funding Corporation, Quarterly Information Statements, Third Quarter.

The aggregate total of loans outstanding at FCS banks and associations (net of intra-System lending) grew by $3.6 billion, or 3.9 percent, during the year ending September 30, 2004, and by $25.2 billion, or 36.2 percent, over the past five years. Volumes in all loan categories were above the levels of five years ago, but for the past two years domestic cooperative and international loans have declined. The total number of members served by FCS associations increased by 1.0 percent to about 415,400 as of the year ending September 30, 2004. Of the 97 FCS associations, 17 experienced double-digit loan volume growth, and 12 experienced drops in loan volume for the past year. The number of loans increased in 37 states, indicating that the System continued to show a strong commitment to its mission of service to agriculture and rural communities.

The System's increased loan volume over the past 12 months stems from long-term real estate loans (up $3.0 billion or 6.1 percent) and short- and intermediate-term loans (up $1.1 billion or 4.5 percent). Marketing and processing loans continued to be among the fastest growing subcomponents of these lending categories. Loan participations and syndications with non-System lenders have also been a major growth area in recent years, but with changes in reporting for these items as of March 31, 2004, we do not have comparable data for earlier periods. Lease receivables reversed the dip of the previous

fiscal year (up 5.6 percent for the Leasing Corporation over the 12 months ending September 30, 2004).

Several factors have facilitated the System's strong loan growth. The funding environment has allowed the System to offer favorable interest rates. Mergers among System institutions have allowed them to provide a wider array of services and products, and System institutions have mounted effective marketing campaigns. And with strong capital positions, a number of System institutions have used participations and syndications, both within and outside the System, as a way of using their capital base while achieving portfolio diversification and risk reduction.

Funding for Other Lenders

Other Financing Institutions

Under the Farm Credit Act, System banks may further serve the credit needs of rural America by providing funding and discounting services to non-System lending institutions known as "other financing institutions" (OFIs). OFIs include commercial banks, thrifts, credit unions, trust companies, agricultural credit corporations, and other specified agricultural lenders. System banks may fund and discount short- and intermediate-term loans for OFIs that are significantly involved in lending to agricultural and aquatic producers and that demonstrate a need for additional funding to meet the credit needs of eligible borrowers. (See page 49 for a brief discussion of a final rule on OFIs that became effective July 22, 2004.) As of September 30, 2004, the number of OFIs served by the System stood at 24, a drop of one institution from a year earlier. However, the number and volume of FCS loans outstanding to OFIs increased in 2004 by 15 percent and 10.9 percent, respectively. Loan volume to OFIs at $339.7 million represented 1.35 percent of the System's short- and intermediate-term loan volume as of September 30, 2004, off from a high of 1.44 percent on September 30, 2001.

Improved Reporting Requirements for Asset Purchases, Sales, and Syndication Data

Under conditions prescribed by the Farm Credit Act, System banks and associations have authority to participate with commercial banks or other financing institutions in making loans to agricultural and other eligible borrowers in rural America. Financial institutions primarily use loan participations and syndications to reduce interest rate risk and credit risk, but they also use them to enhance capital, earnings, and liquidity. Agricultural credit providers with high commodity concentrations frequently use participations and syndications to diversify their portfolios or to fund large loans when they have insufficient capital.

System participations and syndications with non-System lenders have grown rapidly in recent years, reflecting changes in participation rules, as well as favorable market conditions. In the *2003 FCA Annual Report*, we noted an increase of such items outstanding of more than $1.1 billion, or 22 percent, to $6.1 billion for the year ending September 30, 2003, and by $4.6 billion, or 310 percent, over the previous five years.[21] With our improved reporting, we no longer gather comparable information. In March 2004, we provided new guidance on the reporting of syndicated loans (see page 51), and we changed our reporting instructions to obtain more meaningful asset purchases and sales data

21. Up to December 31, 2003, System institutions combined data on participations and syndications in the Call Reports they submitted to the Agency. While participations were reported as being from other System institutions, non-System institutions, or similar entities, participations sold were reported only in total, not separately by type of institution.

between System and non-System institutions.[22] Under the new reporting requirements, the System had $5.6 billion in outstanding loan-type assets that were purchased from non-System institutions, and it had sold $0.8 billion of such assets to non-System institutions. In addition, the System had $2.0 billion in loan syndications outstanding as of September 30, 2004. The $7.6 billion in non-System participations and syndications represented 8.0 percent of the System's total outstanding loans as of September 30, 2004. We anticipate increasing collaboration between System and non-System lenders, thereby expanding the availability of credit to rural America.

FCS Market Share of Farm Debt

According to USDA's estimates of farm sector debt, the System's growth in loans outstanding to farming operations slowed to 4.6 percent during calendar year 2003, less than half its increase during 2002. Its growth rate has outpaced that of all other major farm sector lenders since 2000, resulting in the System's share of total farm business debt jumping from 26.1 percent at year-end 2000 (see Figure 5) to 30.4 percent on December 31, 2003.[23] The System's market share of total farm debt reached a low of 23.9 percent in 1994, following a cyclical high of 33.6 percent at year-end 1982. During the later half of the 1990s, both the System and commercial banks generally experienced small gains in market share. Market share for "individuals and others," as well as USDA's Farm Service Agency (FSA) direct lending, has generally declined in recent years. Meanwhile, the market share for life insurance companies has remained relatively stable over a prolonged period. Although commercial banks continued to have the largest market share at the end of 2003, their share has slipped since December 31, 2000, dropping by 2.3 percentage points to 39.7 percent on December 31, 2003.

As of year-end 2003, the System held 37.1 percent of the market in real-estate-secured farm debt, up half a percentage point during the year. In the non-real estate market, the System held 22.3 percent, up 0.4 percentage points from the previous year.

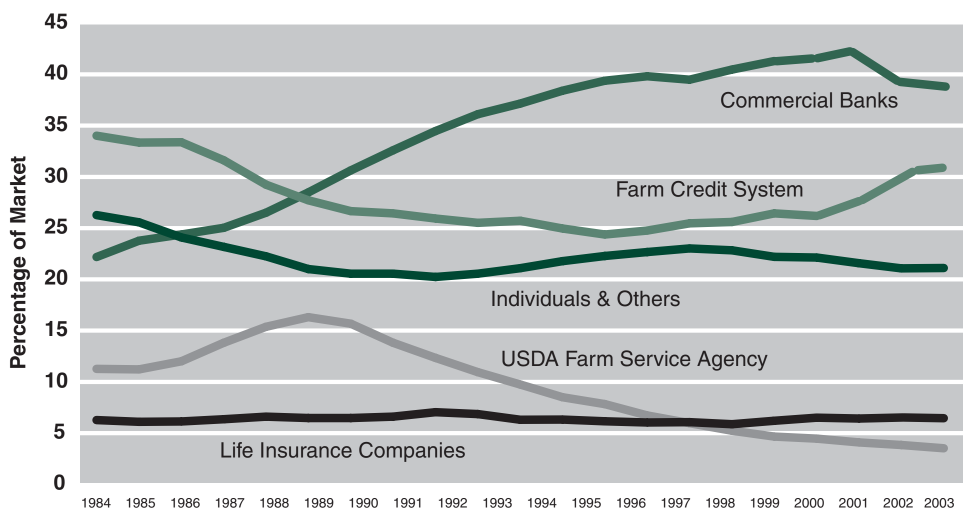
Year-end 2004 loan volume and market share estimates were not available for this report. However, FCS loan data through the third quarter showed continued moderate growth in the System's year-over-year farm real estate loan growth (about 5.0 percent) as well as continuing growth (6.0 percent) in its non-real estate agricultural loan volume. Yearly loan growth patterns reported for commercial banks' agricultural lending through the second quarter show some rebounding (8.3 percent for real estate loans and 2.4 percent for non-real estate loans).[24] Both these sets of lender figures include some loan volume not counted by USDA as farm business debt, but these readings suggest less overall change in market shares in 2004 between the System and commercial banks than has occurred in recent years.

Farmer Mac Provides a Secondary Market

Farmer Mac was created to provide a secondary market arrangement for agricultural real estate and rural housing mortgage loans and greater liquidity and lending capacity to agricultural lenders. In USDA's estimates of farm sector debt by

22. As of March 31, 2004, a new Call Report Schedule RC-O reports up to four types of asset purchases and sales with separate columns for transactions with other System institutions and for transactions with non-System institutions. The four asset types reflect statutory authorities: loan participations, similar entity transactions, lease interest, and other interest in loans. Loan syndications are a new line item reported on Schedule RC-1 Memoranda.
23. Market share percentages are for farm business debt and are based on U.S. Department of Agriculture annual year-end estimates. The historical estimates by lender were revised in October 2003, and final 2003 estimates were issued on November 9, 2004. These data are available on the USDA Economic Research Service Web site. USDA also periodically surveys debt sources used by farm cooperatives. According to the most recent survey (1997), the System provided about 54 percent of the funds borrowed by those cooperatives surveyed. Market share information is not routinely available on the nonfarmer segments of the System's lending activity—namely, its financing of rural homeowners, marketing and processing firms, rural utilities, and international farm commodity sales.
24. Agricultural Finance Databook, Board of Governors of the Federal Reserve System, Statistical Release E.15 (125), Third Quarter 2004.

Figure 5
FCS Regaining Market Share of Farm Business Debt, 1984–2003
As of December 31



Note: "Individuals & Others" includes trade credit, seller financing of real estate, Commodity Credit Corporation storage and drying facility loans, and loans sold to Farmer Mac. Loan volume guaranteed by Farmer Mac, as well as by the USDA Farm Service Agency, is treated as being with the originating lender or purchaser of the loan, not the guarantor agency.

Source: USDA, Economic Research Service. Market shares based on farm balance sheet debt estimates by lender on USDA Web site. Historical series were revised in October 2003, and final 2003 estimates were posted on November 9, 2004.

lender, Farmer Mac's purchases of farm real estate loans (about $3.2 billion outstanding as of September 30, 2004) from various lenders are included as a subcategory of the roughly $41 billion provided in the Individuals and Others category. Farmer Mac also plays a role in the farm debt market through its Long-Term Standby Commitment to Purchase (LTSCP or Standby) product, introduced in 1999. Using the LTSCP, a financial institution acquires a Farmer Mac guarantee for an annual fee on a loan pool that the institution retains. While Farmer Mac's LTSCP product is available to agricultural lenders generally, System institutions accounted for all ($2.4 billion) of the outstanding volume in Standby products as of September 30, 2004.[25]

Since not all farm mortgages are eligible for Farmer Mac funding, Farmer Mac calculates market share achievement by estimating the portion of the total farm real estate debt market that would qualify as eligible mortgages under Farmer Mac's underwriting criteria. Viewing activity in this manner, Farmer Mac estimates outstanding program volume ($5.6 billion) to be about 12.0 percent of the eligible farm real estate debt market.

25. The guaranteed amounts by Farmer Mac are reported in USDA's farm business debt estimates as being provided by the originating lender. This is also how nearly $9 billion in FSA-guaranteed loans outstanding are treated; that is, the 3.4 percent share shown for USDA/FSA was only for its $6.7 billion in direct loans outstanding at year-end 2003.

Table 2

Farm Credit System Major Financial Indicators

Year to Date as of September 30

Dollars in Thousands

Farm Credit System Banks[1]	2000	2001	2002	2003	2004
Gross Loan Volume	$65,967,226	$72,046,891	$78,644,139	$81,819,994	$84,034,986
Accruing Restructured Loans[2]	$179,596	$356,916	$433,659	$14,475	$6,434
Accrual Loans 90 or More Days Past Due	$11,539	$18,529	$41,731	$31,698	$20,273
Nonaccrual Loans	$493,983	$236,356	$411,164	$419,528	$234,733
Nonperforming Loans/Gross Loans[3]	1.04%	0.85%	1.13%	0.57%	0.31%
Cash and Marketable Investments	$14,361,173	$15,266,188	$15,833,066	$19,894,923	$22,508,538
Capital/Assets[4]	7.55%	7.51%	7.04%	6.62%	6.91%
Unallocated Retained Earnings/Assets	4.01%	3.89%	3.95%	3.60%	3.61%
Net Income	$438,813	$487,314	$575,863	$449,593	$476,585
Return on Assets[5]	0.73%	0.74%	0.82%	0.59%	0.60%
Return on Equity[5]	9.55%	9.48%	11.06%	8.93%	8.65%
Net Interest Margin	1.21%	1.20%	1.18%	1.00%	0.93%
Operating Expense Ratio[6]	0.41%	0.38%	0.35%	0.33%	0.34%
Associations					
Gross Loan Volume	$50,030,496	$57,482,274	$65,232,842	$70,492,872	$74,709,800
Accruing Restructured Loans[2]	$81,519	$86,714	$80,255	$95,326	$69,494
Accrual Loans 90 or More Days Past Due	$22,707	$36,535	$48,071	$44,940	$34,124
Nonaccrual Loans	$443,610	$545,193	$587,629	$651,100	$467,847
Nonperforming Loans/Gross Loans[3]	1.10%	1.16%	1.10%	1.12%	0.76%
Capital/Assets[7]	16.86%	16.38%	15.94%	16.00%	16.74%
Unallocated Retained Earnings/Assets	14.03%	13.98%	13.69%	13.95%	14.32%
Net Income	$639,383	$866,295	$780,488	$929,011	$1,024,298
Return on Assets[5]	1.64%	1.94%	1.57%	1.70%	1.78%
Return on Equity[5]	9.73%	11.98%	9.70%	10.63%	10.59%
Net Interest Margin	2.98%	2.86%	2.72%	2.72%	2.73%
Operating Expense Ratio[6]	1.57%	1.47%	1.41%	1.49%	1.47%
Total Farm Credit System[8]					
Gross Loan Volume	$72,957,000	$80,096,000	$87,917,000	$91,302,000	$94,899,000
Accruing Restructured Loans[2]	$123,000	$105,000	$98,000	$113,000	$78,000
Accrual Loans 90 or More Days Past Due	$34,000	$55,000	$90,000	$75,000	$54,000
Nonaccrual Loans	$937,000	$781,000	$1,000,000	$1,070,000	$702,000
Nonperforming Loans/Gross Loans[3]	1.50%	1.17%	1.35%	1.38%	0.88%
Bonds and Notes	$74,369,000	$80,974,000	$87,913,000	$94,002,000	$98,276,000
Capital/Assets[9]	15.52%	15.80%	15.83%	15.76%	16.62%
Surplus/Assets	11.98%	12.22%	12.52%	12.67%	13.10%
Net Income	$1,048,000	$1,295,000	$1,371,000	$1,340,000	$1,415,000
Return on Assets[5]	1.57%	1.78%	1.75%	1.58%	1.57%
Return on Equity[5]	10.18%	11.41%	11.01%	10.08%	9.58%
Net Interest Margin	2.74%	2.79%	2.76%	2.62%	2.52%

1. Includes Farm Credit Banks and the Agricultural Credit Bank.
2. Excludes loans 90 days or more past due.
3. Nonperforming Loans are defined as Nonaccural Loans, Accruing Restructured Loans, and Accrual Loans 90 or More Days Past Due.
4. Capital excludes madatorily redeemable preferred stock.
5. Income ratios are annualized.
6. Operating expenses divided by average gross loans.
7. Capital excludes protected borrower capital.
8. Cannot be derived through summation of above categories because of intradistrict and intra-System eliminations used in the Reports to Investors.
9. Capital includes restricted capital (amount in Farm Credit Insurance Fund), excludes mandatorily redeemable preferred stock and protected borrower capital.

Source: Call Reports received from the Farm Credit System and the Federal Farm Credit Banks Reports to Investors of the Farm Credit System.

Table 3

Farm Credit System Major Financial Indicators, by District[1]

As of September 30, 2004

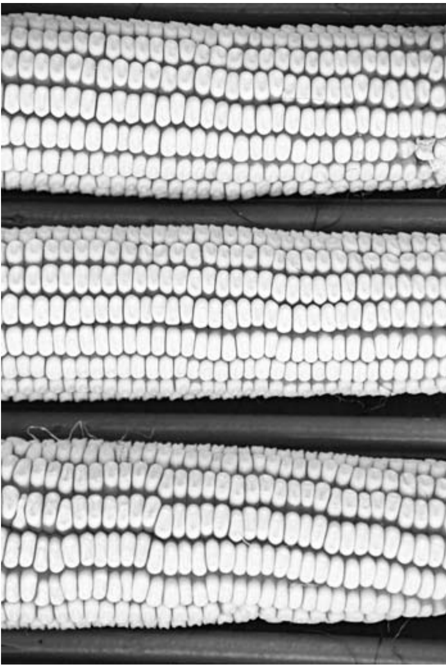
Dollars in Thousands

	Total Assets	Gross Loan Volume	Nonaccrual Loans	Allowance for Loan Losses	Cash and Marketable Investments	Capital Stock[2]	Surplus[3]	Total Capital[4]
Farm Credit System Banks								
AgFirst	$ 16,716,543	$12,778,793	$ 27,523	$ 30,298	$ 3,752,614	$ 379,296	$ 726,586	$ 1,090,551
AgriBank	35,913,355	28,341,946	12,966	72,178	7,351,845	832,122	1,183,820	2,004,305
CoBank	30,027,587	23,268,708	188,318	431,450	6,889,055	1,725,396	1,143,573	2,869,656
Texas	8,454,371	6,633,961	3,088	5,817	1,790,425	208,432	299,887	504,274
U.S. AgBank	15,871,707	13,011,578	2,838	21,366	2,724,599	455,278	521,283	921,503
Total	$ 106,983,563	$84,034,986	$ 234,733	$ 561,109	$22,508,538	$3,600,524	$ 3,875,149	$ 7,390,289
Associations								
AgFirst	$ 13,502,259	$13,188,519	$ 76,278	$ 282,048	$ 13,339	$ 176,568	$ 1,887,461	$ 1,991,705
AgriBank	33,333,077	31,906,636	181,694	623,815	42,946	180,682	5,328,905	5,520,861
CoBank	8,025,077	7,623,386	55,993	165,946	27,664	49,642	1,303,156	1,345,471
Texas	7,553,210	7,406,432	42,449	153,061	15,696	96,348	1,172,999	1,269,347
U.S. AgBank	15,605,005	14,584,827	111,433	226,825	418,976	287,381	2,648,271	2,930,005
Total	$ 78,018,628	$74,709,800	$ 467,847	$1,451,695	$ 518,621	$ 790,621	$12,340,792	$ 13,057,389
Total Farm Credit System	**$121,255,000**	**$94,899,000**	**$ 702,000**	**$2,019,000**	**$23,446,000**	**$1,416,000**	**$15,890,000**	**$20,152,000**

1. Aggregations of district data may not equal totals because of eliminations.
2. Includes capital stock and participation certificates, excludes madatorily redeemable preferred stock and protected borrower capital.
3. Includes allocated and unallocated surplus.
4. Includes capital stock, participation certificates, perpetual preferred stock, surplus, accumulated other comprehensive income, and restricted capital (amount in the Farm Credit Insurance Fund for Farm Credit System total only). Excludes mandatorily redeemable preferred stock and protected borrower capital.

Source: Call Reports received from the Farm Credit System and the Federal Farm Credit Banks Reports to Investors of the Farm Credit System.

Maintaining a Dependable Source of Credit for Farmers and Ranchers



As federally chartered agricultural lending cooperatives, the institutions of the Farm Credit System are single-purpose lenders exposed to risk in making loans to benefit their borrower-stockholders and meet their public mission. While the FCS benefits from preferred access to the capital markets as a government-sponsored enterprise, the Federal government does not subsidize it directly.

For FCS institutions to maintain their presence in the marketplace as a dependable source of credit and financially related services for rural America, they must operate profitably as well as manage and control risk. Accordingly, FCA continues to deploy examination and supervisory resources based on the risk in each institution. This "risk-based" examination and supervisory program requires examiners to determine how certain existing or emerging issues facing an institution or the agriculture industry affect the nature and extent of risks in that institution. On the basis of that risk evaluation, examiners establish examination plans and actions.

To evaluate whether an institution is meeting its pubic mission, examiners determine whether it is operating in compliance with the laws and regulations and whether it is responsive to the credit needs of all types of agricultural producers who have a basis for credit. As a part of their mission, direct-lender associations are obligated to establish programs that respond to the credit and related services needs of young, beginning, and small farmers and ranchers (YBS).

Risk-Based Examination and Supervisory Program

Examinations of FCS institutions must be consistent with Agency authorities and statutory requirements. Within those parameters, the amount of examination review and testing that an institution receives depends on the level of institutional risk reflected by the institution's CAMELS-based rating[26] assigned under FCA's Financial Institution Rating System (FIRS).

The FIRS rating is the primary risk designation FCA uses internally to indicate the safety and soundness threats in an institution. FCA discloses the composite and component ratings to the institution's board to provide a better sense of where the institution stands relative to the seriousness of examination issues. In addition, each report of examination provides the institution board with a detailed assessment of management's performance, the quality of assets, and the financial condition and performance of the institution.

Through its risk-based examination and supervisory programs, the FCA generally devotes fewer resources to institutions that are found to be in compliance with statutory and regulatory requirements and operating in a safe and sound manner. The scope and depth of examinations are based on statutory and regulatory compliance, as well as the risk identified, or reasonably anticipated, in the institution. The factors that determine the scope and depth of an examination include the effectiveness of the institution's internal controls, the examiners' judgment in considering the results of previous examinations, the composite and compo-

26. CAMELS is an acronym for the six general section headings of FCA examinations: capital, asset quality, management performance (including the board of directors), earnings, liquidity, and sensitivity to interest-rate risk.

nent FIRS ratings, changes that have taken place in the institution since the preceding examination (especially implementation of new programs by the institutions), and guidance provided by field and senior management on areas of risk that should be given special emphasis.

Finally, examiners review the work performed by others, such as internal and external auditors or reviewers. The degree of reliance on this work is based on the examiners' judgment of the competence and independence of the auditors or reviewers, as well as the scope of the audit or review.

Meeting Statutory Examination Requirements

The Farm Credit Act requires FCA to examine each FCS institution at least once every 18 months. However, we conduct ongoing monitoring and interim examinations as risk and circumstances warrant in each institution. Generally, FCA examines all System banks and direct-lender associations with more than $1 billion in total assets at least once every 12 to 15 months because of these institutions' relative importance to the overall financial soundness of the System.

FCA conducted 81 examinations in fiscal year (FY) 2004, including examinations of 71 FCS direct-lender associations, four Farm Credit Banks, three service corporations, one Agricultural Credit Bank, Farmer Mac, and the National Cooperative Bank, which is not an FCS institution.[27]

The Small Business Administration (SBA) and the U.S. Department of Agriculture continued to use the FCA's examination expertise in 2004. 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 authorized 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. While the safety and soundness of the System remains our principal focus and responsibility, the use of FCA examination expertise to assist SBA and USDA is a positive reflection on the professionalism of FCA examiners and serves to broaden FCA's examination skills while increasing job satisfaction and employee retention. Reimbursable fees earned from SBA and USDA reduce assessments on FCS institutions.

Measuring the System's Safety and Soundness

Through our continuous monitoring and oversight programs, examiners evaluate the risk in each bank and direct-lender association at least every 90 days on the basis of quantitative and qualitative benchmarks to ensure that assigned FIRS ratings reflect current risk and conditions in the FCS. The FIRS provides a general framework for assimilating and evaluating all significant financial, asset quality, and management factors to assign a composite rating to each institution on a scale of 1 to 5. A 1 rating means an institution is sound in every respect. A rating of 3 means an institution displays a combination of financial, management, or compliance weaknesses ranging from "moderately severe" to "unsatisfactory." A 5 rating signals an extremely high, immediate, or near-term probability of failure.[28]

27. The National Consumer Cooperative Bank Act of 1978, as amended, provides for FCA to examine and report on the condition of the National Cooperative Bank(NCB). Since the passage of this law, FCA has conducted safety and soundness examinations of the NCB and issued reports of examination to the NCB's board.
28. See the Glossary for a complete description of the FIRS ratings.

Throughout FY 2004, FIRS ratings as a whole continued to reflect the stable financial condition of the Farm Credit System; as Figure 6 reflects, the overall trend in FIRS ratings continued to be overwhelmingly positive. At September 30, 2004, there were nearly three times as many 1-rated institutions (77, or 75 percent) as 2-rated institutions (26, or 25 percent). There were no 3-, 4-, or 5-rated institutions at September 30, 2004. These ratings reflect a financially safe and sound Farm Credit System, thanks in part to continuing government support program payments, which enable many borrowers to meet debt obligations when market prices for commodities are low. The overall financial strength maintained by the System reduces the risk to investors in FCS debt, the Farm Credit System Insurance Corporation, and FCS institution borrower-stockholders.

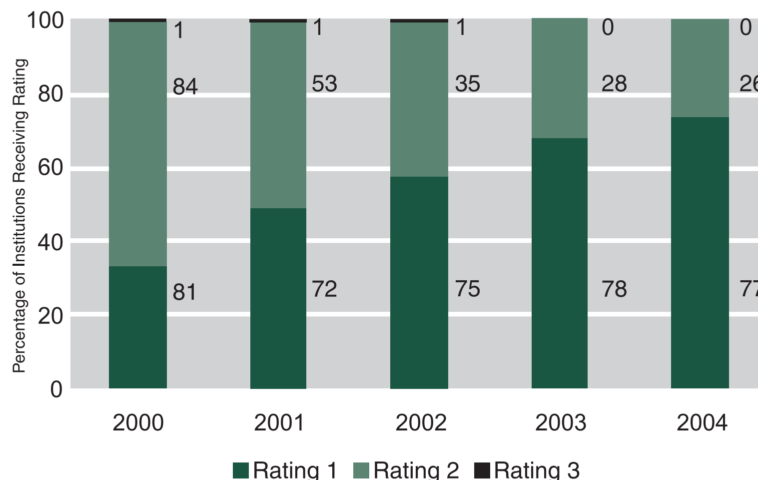
Identifying Potential Threats to Safety and Soundness

Every six months, the FCA's Office of Examination uses a financial forecasting model to identify and evaluate prospective risk in institutions over the upcoming 12- and 24-month periods 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 adverse trends and risk-bearing capacity. This evaluation helps FCA carry out its risk-based supervision program to ensure that FCS institutions address and correct problems before irreparable harm to their financial conditions occurs. Our current financial forecasting analysis (based on December 31, 2003, Call Report data) projects that the financial condition of the FCS will remain sound through December 31, 2004, and December 31,

Figure 6

Farm Credit System FIRS Composite Ratings Steadily Improve

As of September 30



Note: FIRS ratings are based on capital, asset quality, management performance (including the board of directors), earnings, liquidity, and sensitivity to interest-rate risk. Ratings range from 1 (a sound institution) to 5 (an institution that is likely to fail).

Source: Farm Credit Administration Reports of Examination.

2005, under "most likely" and "worst case" scenarios, respectively. These projections assume that current government support programs will continue.

In addition to stress testing, we perform an analysis of new money, refinancing, and rollover trends to identify the potential for transfer of risk from other lenders to FCS institutions (especially during stressful times in agriculture). We also maintain a database of FCS institutions' loan underwriting standards to analyze whether FCS institutional boards are properly adjusting standards in response to changing risk. During FY 2004, the results of these analyses indicated that the use of loan underwriting standards by System institutions has become more widespread, dynamic, and tailored by industry, which we believe will contribute to the System remaining financially sound and well-positioned to fulfill its mission through good and bad times.

Differential Supervision and Enforcement

Risks are inherent in lending, and lending to a single sector of the economy, such as agriculture, is particularly risky. If examiners discover unwarranted risks, they work with an institution's board and management to establish a plan of action to mitigate or eliminate those risks. Appropriate actions may include reducing exposures, increasing capital, or strengthening risk management.

When an institution is not properly managing its risks or complying with laws and regulations, our goal is to use the most appropriate means to influence the institution's board of directors to adjust its polices and practices. When examiners discover unsafe or unsound conditions or violations of laws or regulations, we require, through the report of examination, the institution's board to take corrective actions. The board must provide FCA with a written response that addresses how the problems will be corrected, including specific time frames for correction. Twenty-seven percent of the reports of examination issued in FY 2004 required corrective actions. This follows noticeable increases in 2002 and 2003, when 39 and 87 percent, respectively, of reports required corrective actions, after a three-year declining trend in required actions through 2001. While the percentage of reports requiring corrective actions in 2004 is much lower than it was in 2003, the requirements continued to occur largely in regulatory compliance. Regulatory compliance includes such areas as e-commerce regulation compliance, eligibility and scope of financing, and consumer protection regulations. While not directly affecting safety and soundness, these areas are subject to clear regulatory criteria that warrant FCA's requiring institution boards to take corrective actions.

FCA uses a three-tiered supervision program (normal, special, and enforcement) to distinguish the risks and special oversight needs of institutions. Institutions under normal supervision are generally performing in a safe and sound manner and are operating in compliance with applicable laws and regulations. These institutions have demonstrated they can correct identified weaknesses in the normal course of business. Nonetheless, our examinations may identify violations of laws or regulations or potentially unsafe or unsound practices that require the attention of management and boards and follow-up corrective actions. In addition to required actions, we regularly recommend to institution boards ways to

improve the efficiency or effectiveness of their risk management processes and controls to maintain financial stability. This practice of requiring corrective actions and recommending improvements to processes and controls is critical to our success in preemptively supervising regulatory compliance and the safety and soundness of FCS institutions.

For institutions displaying conditions that are serious but do not necessarily critically impair their safety and soundness, we increase the concern from normal supervision to special supervision, and our examination oversight increases accordingly. Special supervision gives the institution's board and management the opportunity to correct the problems discovered during the examination or oversight process before irreparable harm occurs. This process has been successful where the institution's board and management are both willing and able to correct the identified problems. The institution is allowed time to correct identified weaknesses before enforcement actions by the Agency become necessary.

A formal enforcement action may be necessary if an institution is financially threatened, engages in unsafe or unsound practices, violates laws or regulations, or exhibits excessive risk, or if its board and management are unable or unwilling to correct the problems. After exhausting less formal supervisory approaches, FCA uses its enforcement authorities to ensure that the operations of FCS institutions are safe and sound, and comply with applicable laws and regulations. Our authorities include the power to enter into formal agreements, issue orders to cease and desist, levy civil money penalties, and suspend or remove officers, directors, and any other persons, or forbid them from engaging in FCS institutions' affairs. If the FCA Board votes to take an enforcement action, FCS institutions operate and report under our enforcement supervision program, and our examiners oversee their performance to ensure compliance with the enforcement action.

Working with Financially Stressed Borrowers

Agriculture is a risky business that can be affected by adverse weather; changes in imports, exports, and the Farm Program; and local supply and demand, sometimes causing borrowers difficulty in repaying their loans. Unlike other lenders, the FCS (under provisions of the Farm Credit Act) gives borrowers certain rights when they apply for loans and when they have difficulty repaying loans. For example, the Act requires FCS institutions to consider restructuring an agricultural loan before initiating foreclosure. The Act also provides borrowers an opportunity to seek review of certain credit and restructuring decisions. If a loan is foreclosed, the Act gives borrowers the opportunity to buy back their property at the fair market value.

FCA enforces the borrower rights provisions of the Act. FCA examiners typically include a review of borrower rights compliance in examinations of FCS institutions. Further, FCA receives and reviews complaints from borrowers regarding their borrower rights. Through these efforts, FCA ensures compliance with the law and helps the FCS institutions continue to provide sound and constructive credit and related services to farmers and all types of agricultural producers.

Serving Young, Beginning, and Small Farmers and Ranchers[29]

Providing financially sound and constructive credit and related services to borrowers identified as young, beginning, and small farmers and ranchers is a legislated mandate and a high priority for the System. Loans to YBS borrowers help ensure a smooth transition of agribusiness to the next generation and a continued diversified customer base for the FCS that includes all sizes of farm operators.

The percentage of retirement-age farm operators continues to rise, increasing the importance of the Farm Credit System's role in helping young and beginning farmers finance the purchase of land sold by those who are exiting the business. The 2002 Census of Agriculture found that 26.2 percent of principal operators are age 65 or older, compared with 21.4 percent in 1987. The census also reported a continuing sharp decline in the percentage of young operators (principal operators age 34 or younger), dropping from 13.3 percent in 1987 to 5.8 percent in 2002.

Transitions out of and into the capital-intensive farming business involve credit decisions that are compounded by the volatile nature of agricultural production and prices, as well as shifts in the products consumers desire. System lenders prudently weigh the risks and rewards of extending credit to new customers by assessing their long-term earnings potential and risk management ability.

The Farm Credit System with its GSE status is in a unique position to develop YBS programs, coordinate those programs with other government programs that can spread risks, and make a continuing commitment in lending to YBS borrowers. Many borrowers are assisted by the various state and Federal programs that provide interest rate reductions or guarantees to help commercial lenders and FCS institutions reduce credit risks for borrowers. Without such concessions and guarantees, credit would not be extended to some YBS borrowers because of repayment risks.

Section 4.19 of the Farm Credit Act and FCA Regulation 614.4165 require each System bank and association board to have a program in place for furnishing sound and constructive credit and financially related services to YBS borrowers. YBS programs are to be made available in coordination with those of other System institutions and with other government and private sources of credit. In addition, each institution is required to report yearly on operations and achievements under its YBS program.

FCA Adopts New YBS Rule

In March 2004, FCA approved a final rule designed to enhance the System's service to YBS farmers and ranchers. The rule amends existing regulations to provide clear, meaningful, and results-oriented guidelines for the YBS policies and programs of the System's institutions. It also provides for enhanced reporting and disclosure to the public on the System's performance and compliance with its statutory YBS mission. While the rule provides for additional guidance, it also allows System direct-lender associations the flexibility to design YBS programs unique to the needs of their territories and within their risk-bearing capacities. (See page 48 for a summary discussion of the new YBS regulation.)

29. The System's YBS mission is to the three separate borrower categories (young, beginning, and small), not to a combined characteristic YBS borrower. Thus, when we use the term YBS, we are referring to the service to each component.

The YBS rule was the first substantive mission-related regulation adopted by the FCA Board. It was developed with considerable public participation that was achieved through a public meeting (November 2002) and requests for written responses to a proposed rule in the *Federal Register* (September 2002 and September 2003).[30] We heard testimony from 24 interested parties at the public meeting and received 52 comment letters in response to the proposed rule. We believe the rule is well-balanced and satisfies the recommendations in a General Accounting Office (GAO)[31] report of March 2002 on the FCA's oversight of the System's special mission to serve YBS farmers and ranchers.[32]

Over the past six years, the Agency has taken a number of actions designed to provide additional emphasis and guidance to System institutions as they lend to YBS borrowers. The first major action was a policy statement (FCA-PS-75) on YBS farmers and ranchers adopted by the FCA Board in December 1998. The policy statement emphasized the need for each System institution to renew its commitment to be a reliable, consistent, and constructive lender for YBS borrowers. The statement was implemented with a Bookletter (BL-040) to the System in December 1998 that provided guidance in the form of new YBS reporting definitions and reporting procedures that were fully phased in by January 1, 2001.

The new rule rescinds and replaces the December 1998 FCA Board policy statement on YBS farmers and ranchers. It retains the YBS reporting definitions in the December 1998 Bookletter to the System that were fully phased in by January 1, 2001. Additional guidance on YBS programs and reporting requirements of the new rule will be communicated to reporting institutions through our regular Call Report instructions.

A number of developments have improved our ability to analyze and report on the System's service to all YBS borrowers. Beginning in 1999, our examinations of System institutions included a focus on YBS programs, reviewing bank policy statements, data collection, and reporting to the institution's board. The GAO report of March 2002 recommended that the Agency strengthen its oversight role of the System's YBS lending, promote YBS compliance, and highlight the System's efforts to provide service to YBS farmers and ranchers in the following ways:

1. Promulgate a regulation that outlines specific activities and standards that constitute an acceptable program to implement the YBS statutory requirement;
2. Ensure that examiners follow the guidance and complete the appropriate examination procedures related to YBS and adequately document the work performed and conclusions drawn during examinations; and
3. Publicly disclose the results of examinations for YBS compliance for individual System institutions.

The immediate FCA response was to develop a comprehensive YBS examination program and issue additional guidance for System institutions in the form of a YBS-related self-audit program. The guidance encouraged System institutions to adopt clearly stated policies for serving YBS borrowers and to develop and use a variety of management controls over program operations to help ensure the

30. See the *Federal Register* (69 FR 16470, March 30, 2004) for the final rule, with background and a discussion of comments received.
31. Effective July 7, 2004, GAO's legal name became the Government Accountability Office.
32. "Farm Credit Administration: Oversight of Special Mission to Serve Young, Beginning, and Small Farmers Needs to Be Improved," GAO-02-304, March 8, 2002.

effectiveness of their YBS programs. A subsequent GAO report on this area found FCA's lead sheet for YBS examinations to be "a useful tool for FCA in examining institutions for compliance with the special mission requirement of serving YBS farmers and ranchers."

These FCA actions have encouraged System institutions to evaluate their performance in YBS lending by analyzing their lending markets and assessing their own market penetration. If this assessment suggests that an association needs to penetrate the YBS market further, we encourage the association's board of directors to develop new programs, strengthen existing programs, or provide added incentives to contribute to the success of their marketing programs to these farmers. Thus, FCA's oversight increases awareness of the mission in this area and prompts associations to provide added resources to serve this market segment. FCA has also developed a mission-related performance measure for YBS programs based on an evaluation of the effectiveness of every direct-lender association's YBS program. This measure allows us to evaluate our success in ensuring that associations maintain adequate YBS lending programs.

In establishing their YBS programs, institutions may use a variety of tools to carry out their commitment to YBS lending. For example, associations may offer less stringent underwriting standards or reduced interest rates to make it easier for potential YBS borrowers to qualify for loans. Some institutions establish special risk pools in which capital is set aside to support YBS lending. Almost all programs provide for coordination with Federal or state sources to obtain guarantees on loans to qualifying YBS borrowers. Many YBS programs provide for financial or leadership training or related services for YBS borrowers. In addition, associations donate to or sponsor special events for local, regional, and national young or beginning farmer groups.

YBS Loans and Commitments Outstanding

YBS loans and loan commitments outstanding provide a view of loans on the books of System institutions at the end of the year. As of year-end 2003,[33] 17.0 percent of the number of the System's loans outstanding to farmers and ranchers were to young borrowers, defined as those 35 years old or younger (see Table 4, page 34). Beginning borrowers (those with 10 or fewer years of farming experience) accounted for 21.8 percent of loans. Loans to small farmers (those with annual sales of less than $250,000) accounted for 59.7 percent.[34] The corresponding percentage figures for the total dollar volume of loans outstanding were 12.9, 18.7, and 31.8 percent. The System's 2003 percentages in all but the first of these six categories were slightly higher than for 2002, and all six of the 2003 percentages were higher than those at year-end 2001. Average loan sizes for YBS loans outstanding varied from $68,357 for small farmers to $110,169 for beginning farmers.

YBS Loans and Commitments

Loans and commitments made offer a view of lending activity during the year, providing a measure of the System's current performance in serving YBS borrowers. FCS institutions made 150,093 loans to small farmers in 2003, 58.7 percent of the number of all new loans made to farmers that year. A total of $11.0 billion in loans was made to small farmers

33. System data on service to YBS farmers and ranchers cover the calendar year and are reported at year-end. The 2004 data will be available in April 2005.
34. YBS data are reported for individual young, beginning, or small categories. It is not meaningful to add two or three YBS categories together, since the categories are not mutually exclusive. Depending on borrower characteristics, a borrower may be counted in two or even all three categories (e.g., many borrowers are likely to fall into all three categories—young, beginning, and small). The data on loan numbers are not the same as counting the number of farmers, since it is not unusual for individual member-borrowers to have multiple loans.

Table 4

Loans Outstanding at December 31, 2003, Benefiting Young, Beginning, and Small Farmers and Ranchers[1]

Loan Type	Number of Loans	Percentage of Total Number	Volume of Loans ($ millions)	Percentage of Total Volume	Average Loan Size
Young Farmers and Ranchers	119,121	17.0	$11,587	12.9	$97,271
Beginning Farmers and Ranchers	153,225	21.8	$16,881	18.7	$110,169
Small Farmers and Ranchers, by Loan Size					
$50,000 or less	249,043	65.9	$ 4,742	66.0	$ 19,042
$50,001–$100,000	89,254	62.8	6,243	62.8	69,944
$100,001–$250,000	63,384	53.4	9,354	51.4	147,582
More than $250,000	17,541	27.7	8,317	15.2	474,154
Total Loans to Small Farmers and Ranchers	419,222	59.7	$28,657	31.8	$ 68,357

1. A young farmer is defined as 35 years old or younger when the loan is made; a beginning farmer has 10 years or fewer of farming or ranching experience; a small farmer is one who typically generates less than $250,000 in annual sales of agricultural or aquatic products. Since the totals are not mutually exclusive, one cannot add across young, beginning, and small categories to count total YBS lending.

Source: Annual Young, Beginning, and Small Farmer Reports submitted by each Farm Credit System lender through the Farm Credit banks.

Table 5

Loans Made During 2003 Benefiting Young, Beginning, and Small Farmers and Ranchers[1]

As of December 31

Loan Type	Number of Loans	Percentage of Total Number	Volume of Loans ($ millions)	Percentage of Total Volume	Average Loan Size
Young Farmers and Ranchers	39,033	15.3	$4,353	12.0	$111,510
Beginning Farmers and Ranchers	50,726	19.9	$6,545	18.1	$129,023
Small Farmers and Ranchers, by Loan Size					
$50,000 or less	88,078	67.4	$1,688	67.0	$ 19,164
$50,001–$100,000	31,067	60.2	2,183	63.9	70,260
$100,001–$250,000	23,749	52.6	3,608	52.6	151,905
More than $250,000	7,199	25.6	3,497	14.9	485,756
Total Loans to Small Farmers and Ranchers	150,093	58.7	$10,975	30.3	$ 73,123

1. A young farmer is defined as 35 years old or younger when the loan is made; a beginning farmer has 10 years or fewer of farming or ranching experience; a small farmer is one who typically generates less than $250,000 in annual sales of agricultural or aquatic products. Since the totals are not mutually exclusive, one cannot add across young, beginning, and small categories to count total YBS lending.

Source: Annual Young, Beginning, and Small Farmer Reports submitted by each Farm Credit System lender through the Farm Credit banks.

in 2003, 30.3 percent of the dollar volume of loans made during the year. The average loan size of small farmer loans made during 2003 was $73,123. Because of the much greater credit needs of larger farmers, the average size for all System farm loans made was about twice the average for small farmer loans. (See Table 5 for percentages and averages for young and beginning farmers.)

Assessment of YBS Results for Individual Associations and the System

As in the previous two years, individual associations vary significantly in their YBS lending results. No single association has the highest System percentage in all three or even two of the YBS categories. Table 6 (see page 36) shows the wide range in the 2003 results for individual associations using percentage-of-loan numbers for each YBS category for loans made and outstanding loans. A similar range occurs in the loan volume data. These wide ranges also occurred in the 2001 and 2002 results.[35]

The range in association results for the number of loans to small farmers is much greater than for young or beginning farmers (from a low of 14.4 percent of loans made to a high of 92.6 percent). For young farmers, the range is considerably smaller, from 6.5 percent to 28.8 percent of loans made, while for beginning farmers the corresponding range is from 7.6 percent to 69.6 percent. In general, we would expect loan portfolios to have the highest percentage in the “small” category. The 2002 Census of Agriculture classified about 93 percent of all farms as small, using the same definition for a small farm as that used for YBS reporting. With the System’s overall average at just under 60 percent for the number of loans outstanding, this result seems relatively low. But note that the 2002 Census of Agriculture found that nearly 39 percent of all farms had sales of $2,500 or less. The Census of Agriculture also reported that less than half of all small farms had interest paid as a farm business expense. Thus, the 60 percent may be a strong rather than weak result.

Significant differences in results among institutions are to be expected given the significant differences in farming operation sizes and farmer demographics across the United States. For example, in 2003, farms in California had average annual sales of $354,200, compared with $26,900 in Tennessee (7.6 percent of the California average). It is no surprise that results for small farmer portfolio concentrations in these states tend to reflect these differences. Census of Agriculture data also show that the average age of farmers varies considerably from state to state. Such differences make comparisons among individual associations difficult and explain why the new YBS rule does not specify fixed goals. Other factors—such as the competitiveness of the local lending market and the availability of USDA Farm Service Agency guarantees—play a role in individual association results.

Despite all these factors, however, institutions with young, beginning, or small farmer or rancher portfolio percentages at the low end of the range are carefully reviewed during the examination process to assess the role of local demographic or economic factors versus the role of management in determining YBS outcomes. The trend in YBS results within an institution is an important factor in assessing the success of YBS programs. Examination follow-up focus is on cases in which improvements in management can play a key role in increasing YBS lending.

Three Years of Comparable YBS Data

We now have three years of System YBS results under the definitions and reporting requirements that became mandatory in 2001. In addition, all institutions have had thorough examination reviews of their YBS reporting. In some cases, these reviews have resulted in corrections of previously reported YBS data. As illustrated in Figure 7 (see page 36) and Figure 8 (see page 37), fairly strong upward trends have occurred in both the numbers and loan volumes made for each of the three program areas over the 2001–2003 period. Similar results exist for the numbers and volumes of loans outstanding. These results are for the actual counts

35. Additional YBS data by institution, district, and the System beginning with 1999 are available on FCA’s Web site, www.fca.gov.

Table 6

Wide Range in YBS Program Results by Association[1]

As of December 31, 2003

Percentage of Total Loan Numbers[2]

Program	Loans	Range by Association Low	Range by Association High	Overall Average
Young	Outstanding	7.7	28.0	17.0
	Made	6.5	28.8	15.3
Beginning	Outstanding	10.1	56.2	21.8
	Made	7.6	69.6	19.9
Small	Outstanding	13.5	92.1	59.7
	Made	14.4	92.6	58.7

1. A young farmer is defined as 35 years old or younger when the loan is made; a beginning farmer has 10 years or fewer of farming or ranching experience; a small farmer is one who typically generates less than $250,000 in annual sales of agricultural or aquatic products.
2. The percentages shown are of total loan numbers outstanding as of December 31, 2003, and of total number of loans made in 2003.

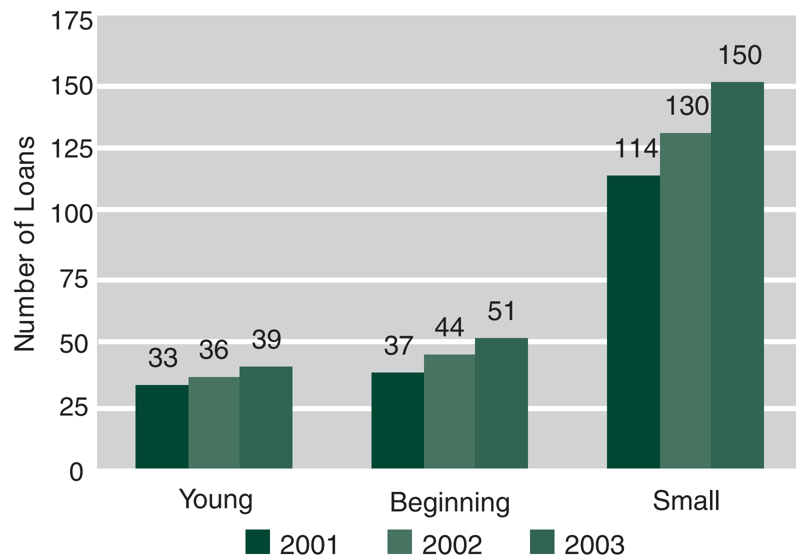
Source: Annual Young, Beginning, and Small Farmer Reports submitted by each Farm Credit System lender through the Farm Credit banks.

Figure 7

Number of YBS Loans Made Each Year Steadily Increases, 2001–2003

As of December 31

Loan Count in Thousands



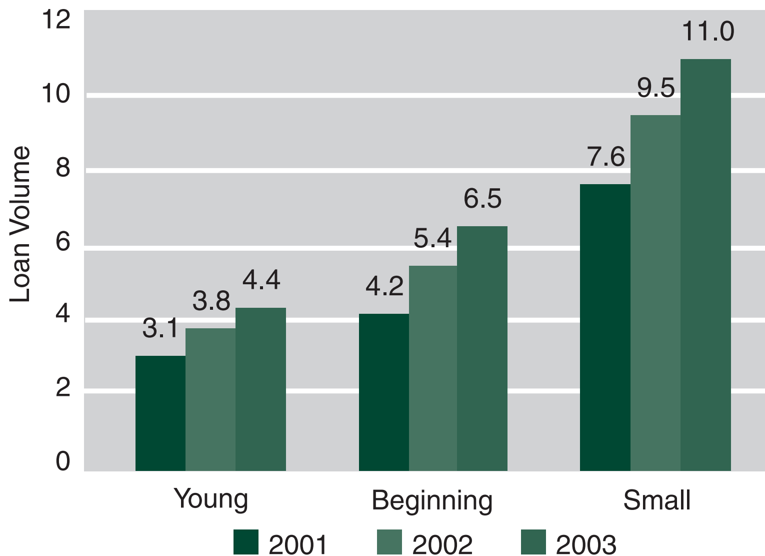
Source: Annual Young, Beginning, and Small Farmer Reports submitted by each Farm Credit System lender through the Farm Credit banks.

Figure 8

Dollar Volume of YBS Loans Made Each Year Grows, 2001–2003

As of December 31

Dollars in Billions



Source: Annual Young, Beginning, and Small Farmer Reports submitted by each Farm Credit System lender through the Farm Credit banks.

and dollar volumes. If the results are expressed as a percentage of total loans made or outstanding, the uniform patterns of increase change marginally. Slight dips occurred in the percentages of total loan numbers made and outstanding for young farmers. The 2003 percentages cited in Table 6 (15.3 and 17.0) for loans made and outstanding were 15.7 and 17.1, respectively, in 2002. But even with these small declines, the results appear to be solid performances, given the steep downward trend in the percentages of young farm operators noted in recent Census of Agriculture reports (age groups and measurements differ somewhat).

Notwithstanding the overall favorable YBS results for the System, a number of individual institutions experienced declines in their percentages for the various YBS measures. For example, of 99 associations at year-end 2003 (and comparing their 2003 results with their equivalent 2001 results), 55 showed declines in the percentage of the number of loans made to young farmers, 33 showed declines in loans to beginning farmers, and 26 showed declines in loans to small farmers. However, one could also say that, with the exception of number of young farmers, more than half the System's associations had positive three-year trends in loans made. Further, more than half had positive trends in YBS volume, as well as in the six categories for outstanding loans to YBS farmers. It is important to note, however, that comparisons over only three years do not establish a firm trend. In addition, results are affected by ongoing YBS examinations that have, in many cases, resulted in examiners requiring associations to correct deficiencies in their YBS reporting and, in a few cases, caused them to restate their 2001 and 2002 results.

Comparisons in YBS lending cannot be made between FCS institutions and other lenders because other Federal regulators do not require reporting on young and beginning farmer loans. While large banks are required to report on small farm loans,

small farm lending is defined in terms of loan size (a loan less than $500,000) rather than in terms of the borrower's annual sales. In addition, because of differences in data definitions and data collection methods, annual YBS data are not comparable to Census of Agriculture data, which are collected only once every five years.

YBS Programs

Each FCS association responds to an annual Agency questionnaire on the content of its YBS program. While we typically modify or refine the questions each year, the survey basically covers program goals, board reporting, YBS credit provisions, use of government guarantee programs, and use of training or other related services. By year-end 2003, the number of institutions with specific YBS goals had increased significantly to 96 percent of all associations, compared with 53 percent in 2001. This percentage has increased in part as a result of the Agency's strong encouragement that all institutions have quantitative YBS goals. Goals are required by the new regulation, as are demographic comparisons. As noted earlier, goals are not set by FCA but by each institution based on local conditions. The goals are typically stated as a specific percentage of outstanding loans in each young, beginning, or small farmer or rancher category reflecting the institution's demographic studies. In the future, FCA examinations will focus on the quality of the goals.

Another question concerns association board oversight and frequency of board reporting. In 2003, all associations reported to their boards on YBS performance at least annually; more than 70 percent reported quarterly or more often. In 2001, only 63 percent of the associations reported to their boards annually, and some did not have regular reports on YBS results. The new regulation requires a quarterly reporting cycle, highlighting the importance of YBS activities at the board level and enabling a board to take timely corrective action if an association's YBS goals are not being realized.

YBS programs at many System associations make loan qualification easier by applying differential underwriting standards or allowing exceptions to normal underwriting standards. The differential underwriting standards often include higher loan-to-market value ratios or lower debt requirements for YBS borrowers.

During 2003, 71 percent of the associations offered differential underwriting standards, or exceptions, for YBS borrowers, up from 60 percent in 2001. Also, some associations reduced borrowing costs through lower interest rates or fees. More than half (58 percent) had programs that offered lower interest rates, and nearly 40 percent offered lower loan fees for YBS borrowers. In most cases, institutions used more than one credit enhancement program.

As noted, the Farm Service Agency is the primary agency offering government-guaranteed loans for farmers, although a small portion of guaranteed loans is made through the Small Business Administration and various state programs. System lending institutions often use the FSA's guaranteed lending program, especially for YBS lending. In our 2003 survey, we asked the System for specific figures on the use of FSA guarantees for separate YBS loan categories. The counts and volumes of YBS loans with FSA guarantees during 2003 and at year-end represent significant proportions of the System's overall FSA guarantees. About one-fourth of the overall number of the System's FSA-guaranteed loans outstanding were to young farmers; one-fourth were to

beginning farmers; and more than half were to small farmers (numbers are not additive).

An increasing number of associations offer a growing array of training programs or other services that benefit YBS farmers and ranchers. The most common training program focuses on leadership; 60 percent now offered this training. Approximately 65 percent offered training in business and financial management skills. Most associations also offer other financial services programs, including estate planning, recordkeeping, tax planning and preparation, and farm business consulting. Sometimes associations discount or waive the cost of these programs for YBS farmers and ranchers.

Other outreach activities are offered in conjunction with organizations such as state or national young farmer groups, colleges of agriculture, state or national cooperative association leadership programs, and local chapters of 4-H or the National FFA Organization. Many associations also provide financial support for scholarships, FFA, 4-H, and other agricultural organizations.

Helping Farmers through Federal and State Loan Guarantees

Use of USDA's guaranteed farm loan programs, administered by the Farm Service Agency, has been increasing among System institutions.[36] The programs give lenders an opportunity to reduce their credit risk while making loans to borrowers who would not otherwise meet the underwriting standards. The programs also make it easier for lenders to continue financing existing borrowers who may be relatively new to farming or may be facing financial hardship. A number of states also offer programs to help these farmers, including linked deposit accounts, Aggie Bonds, and other low-interest programs, as well as guarantees, direct loans, and loan participation programs.[37] While FSA guarantees account for the vast majority of government-guaranteed farm loans, the following discussion also includes results from state agency farm loan guarantee programs.

The FCA encourages Farm Credit System lenders to use government-guaranteed farm lending programs to help expand YBS lending and meet the needs of other eligible borrowers in the agricultural community. Guaranteed loans reduce lending risk and are given preferential treatment in the application of risk rating systems and in determining their regulatory capital ratios. Normally, loans guaranteed by USDA or other U.S. government agencies that are performing as expected are classified as acceptable/performing loans. Also, even though repayment problems or other credit weaknesses may exist, examiners do not take exception if the institution maintains the loan in an accrual accounting status. Further, institutions are not required to maintain as much capital for guaranteed loans (20 percent risk weight versus 100 percent for nonguaranteed loans) when determining their regulatory capital ratios.

Although System institutions take advantage of the FSA and state guarantee programs to help a wide range of borrower types, the largest group of borrowers assisted is the System's young, beginning, and small farmers and ranchers. Roughly twice as many YBS loans carry FSA or state guarantees as does the overall portfolio of the System's direct lenders.

Over the five-year period ending September 30, 2004, total loans outstanding to farmers with FSA or state guarantees increased by $1.13 billion to $2.27 billion, or about 100 percent. As illustrated in

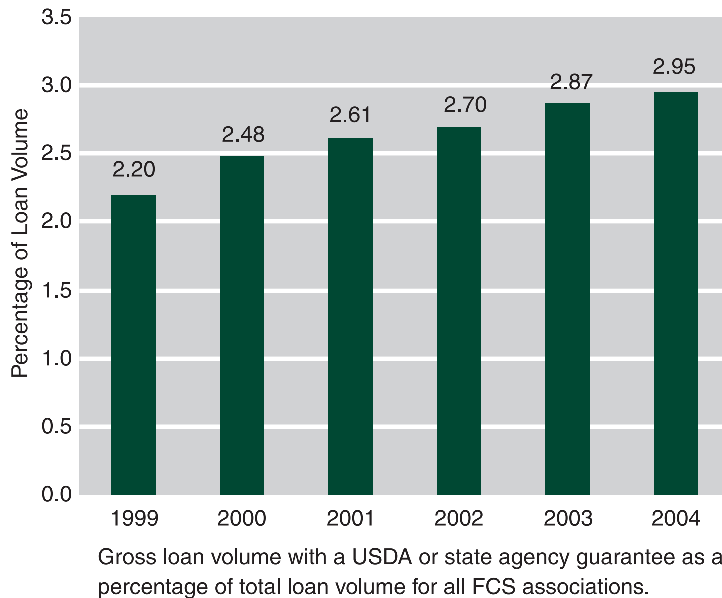
36. FSA typically guarantees 90 percent of the loan principal. To qualify, borrowers must be unable to obtain sufficient credit elsewhere at reasonable rates and terms and must meet minimum cash flow requirements. Lenders must pay a 1 percent guarantee fee that can be passed on to the borrower.
37. See the Web site www.stateagfinance.org for more information and a list of states offering the various types of programs.

Figure 9, the System's volume under guaranteed loan programs is increasing relative to its overall loan volume. As of September 30, 2004, 14,978 of the System's loans to farmers (2.95 percent of its volume) were reported as having FSA or state guarantees, compared with 10,252 loans (2.20 percent of its volume) five years earlier.[38] The System has also been steadily increasing its share of all FSA-guaranteed loans, from 15.1 percent five years ago to 24.6 percent as of September 30, 2004. However, the System's share of FSA guarantees is below its overall market share of farm debt.

Most (93 of 97) System associations participate in the FSA or state guarantee programs, with 74 institutions having 20 or more loans in these programs. Use at individual associations continues to vary widely: 28 associations had FSA- or state-guaranteed volumes of more than 6 percent of their total lending volume as of September 30, 2004; however, almost as many (24) had guaranteed lending volumes of 1 percent or less of their outstanding loan volume. The top 10 associations in terms of dollar volume guaranteed account for 46 percent of the System's FSA- or state-guaranteed loans. Each of these associations had more than 350 FSA guaranteed loans, and they are FSA Preferred Lenders.[39]

Institutions that are heavy users of the FSA or state guarantee loan programs note that guarantees reduce portfolio credit risks and are especially helpful in promoting lending to YBS borrowers. These institutions have made the extra effort to learn about the FSA and state guarantee loan programs and to develop procedures to participate in them. They also typically have good relationships with FSA and state agency personnel in their areas. Nearly 40 FCS associations increased their FSA- or state-guaranteed lending volume by 10 percent or more as of September 30, 2004. Even so, roughly 45 percent of all associations had either no change or a decrease in their guaranteed volume. On average, this group had 2 percent of their loan volume under FSA or state guarantee programs, suggesting that the System has significant potential for expanded use of such programs.

Figure 9
FCS Increases Use of Guaranteed Farm Loans, 1999–2004
As of September 30



Gross loan volume with a USDA or state agency guarantee as a percentage of total loan volume for all FCS associations.

Source: FCA Loan Account Reporting System.

38. Loans to farmers include rural housing loans (some of which are to nonfarmers), marketing and processing loans, farm-related business loans, and miscellaneous loans. A small additional volume of Federal guaranteed lending is under other programs. The System also had $2.4 billion guaranteed under Farmer Mac's Long-Term Standby Commitment to Purchase program as of September 30, 2004.
39. The FSA Preferred Lender Program (PLP) allows better performing lenders to make efficient use of the FSA guarantee program through reduced paperwork requirements; as of September 30, 2004, FSA reported that 57 FCS institutions had PLP status.

Challenges Facing Agriculture, the Rural Economy, and the FCS

Farm Credit System institutions and their borrowers face a variety of challenges, both domestic and foreign, that can affect their performance and viability. The FCA monitors and analyzes a wide range of factors that influence the agricultural economy and the financial sector and that could pose significant risks to farmers, ranchers, aquatic producers, agricultural cooperatives, the institutions that comprise the Farm Credit System, and rural communities in general. While System institutions have exhibited favorable credit quality and maintained satisfactory earnings to strengthen capital positions during 2004, a number of risks and uncertainties remain largely beyond the control of the System and FCA.

Mixed Outlook for the General Economy

The U.S. economy continued to expand in 2004, as the consumer-led recovery in the first half of the year gave way to an investment-led growth phase in the second half of the year. Rising consumer demand encouraged producers to invest in new plant and equipment and hire more workers, which reduced the unemployment rate to the lowest level since 2001. Rising costs for energy, food, housing, and consumer goods in general resulted in a slight increase in inflation for 2004. However, price increases remain low by post-World War II standards.

The outlook for the U.S. economy in 2005 is for a continued expansion but at a more sustainable level than the robust growth that occurred in 2004. More hiring by businesses is expected to further reduce the unemployment rate in 2005, but the improved job picture will vary by region and state, with the strongest improvements likely to occur in the South and the West, followed by the Northeast and the Midwest. Labor-saving technology, job outsourcing, and the high cost of health insurance and retirement benefits are constraining the employment rebound and are key factors that will determine the ability of U.S. businesses to remain competitive in the future. Off-farm employment is a key source of income for many farm families: More than half of farm operators and their spouses work off the farm today. Nonfarm income accounts for more than 90 percent of farm family household income on average, and nearly 50 percent for large family farms (those with annual sales between $250,000 and $499,999).

Rising employment and income levels should lead to higher spending for food items, particularly for higher valued meats, dairy products, and horticultural products, as well as for more eating out. The rising demand for meat and dairy products will expand the feed use of grains and protein crops, while recent concerns over obesity and the popularity of specialized diets have reduced the consumption of starchy foods and certain confectionary products. If the current diet trend becomes more than a passing fad, producers of food grains and sugar crops could see a further dwindling of their markets, which would require an adjustment to their product mix to remain profitable.

Oil Markets Unsettled

Inflation is expected to ease somewhat in 2005, with slower growth in consumption and business spending, along with moderation in prices for both food and energy because of improved supply conditions. However, a major risk to this outlook is the unsettled situation in the world petroleum market. Crude oil futures prices breached the psychological

barrier of $50 a barrel in late September 2004, as traders cited political instability in the Middle East and Nigeria and disruptions to oil supplies in the Gulf of Mexico from a very active hurricane season. However, in inflation-adjusted terms, the price of crude oil today is about 25 percent less than the record price set in 1981. Petroleum prices fell below $50 a barrel in November 2004 but could easily rise above that level again, depending on developments in the Middle East.

The United States continues to increase its dependence on imported petroleum, with imports as a share of total supply increasing from 47 percent in 1991 to an estimated 68 percent in 2004. Around 20 percent of U.S. imported petroleum comes from Persian Gulf countries (mainly Saudi Arabia and Iraq), and another 10 percent comes from Africa (mainly Nigeria and Algeria), a fact that underscores U.S. vulnerability to oil price shocks. On a more positive note, the ban on the fuel additive methyl tertiary butyl ether in California, which took effect on January 1, 2004, has given a boost to the ethanol industry as well as to corn growers. As the automotive fuel industry makes the switch to an alternative fuel additive to reduce auto emissions, demand prospects for U.S. grain producers will strengthen.

Interest Rates on the Rise

With the economy expanding at a fairly solid pace, improving labor market conditions, and slightly elevated inflation, the Federal Reserve Open Market Committee began a series of quarter-percent increases in its Federal funds rate beginning on June 30, 2004; this pace is designed to both sustain growth and maintain price stability. The Fed's action represented the first rate increase in more than four years and marked the end of an era that saw interest rates drop to their lowest level since 1958. The low interest rate environment contributed to a refinancing boom at Farm Credit System institutions and other agricultural lenders over the past three years and improved financial positions for farmers and ranchers, who were able to cut costs by reducing debt payments. It also provided opportunities for those wishing to begin or expand a farming operation.

The favorable level of credit quality that characterized FCS institutions in recent years continued in 2004, enabling them to strengthen their portfolios and further build their capital bases. Interest rates—and, therefore, System debt cost and loan rates—are expected to rise in 2005 as the economy continues to grow but are expected to remain low by historical standards. Borrowers with variable-rate loans will see their debt costs rise, although at a manageable pace (except for the most heavily leveraged operations).

Record Farm Income Could Slip in 2005

Robust demand (both at home and abroad), smaller foreign supplies, and record prices for crops and livestock products propelled U.S. farm income to a record-setting level in 2004. Net farm income for 2004 is estimated to reach $73.7 billion, nearly 25 percent above the previous record set last year and around 50 percent above the most recent 10-year average. On the flip side, higher prices for animal feed, petroleum products, and fertilizers contributed to a record level for production expenses in 2004.

Direct government payments to farmers are estimated at $15.7 billion in 2004, only slightly below the $15.9 billion farmers received in 2003. The weakening of program crop prices around harvest time resulted in higher government payments than previously expected. Government payments as a share of net farm income are estimated around 21 percent for 2004,

down sharply from a high of 48 percent in 2000 but still high compared with payments in 1996, when they accounted for just 13 percent of net farm income.

The outlook for 2005 is for larger crop supplies and stiffer competition from foreign exporters, leading to a decline in commodity prices, cash receipts, and farm income, though these are all expected to remain at high levels by historical standards. Lower commodity prices in 2005 are expected to lead to higher countercyclical government payments.

The downside risk to borrowers and their lenders in the future would be reductions in government payments as part of the U.S. commitment to the multilateral trade talks of the World Trade Organization (WTO). The WTO ruled in June 2004 that U.S. subsidies to cotton producers were in violation of international trade rules and would have to be modified. The case was officially filed by Brazil but had the backing of cotton-producing countries in Africa, environmental groups, and development organizations. While no immediate change in U.S. cotton programs is expected, the ruling should be viewed as a warning about the future of government support programs.

Farm Real Estate Values

Real estate makes up the bulk of farm business assets in the United States, accounting for about 80 percent of total assets in recent years. U.S. farm real estate values continued their upward climb in 2004, the 17th annual increase since the collapse of the farmland market in the mid-1980s. Persistently strong demand for farmland for nonfarm uses, record profits in some segments of the agricultural sector, and historically low interest rates have led to a robust farmland market in recent years.

The average value of farm real estate (all land and buildings on farms, excluding Alaska and Hawaii) reached $1,360 per acre as of January 1, 2004, an increase of $90 per acre (7.1 percent) from a year earlier. This is the largest percentage increase in farm real estate values since 1994 and the second largest increase in 23 years. In inflation-adjusted dollars, farm real estate values are still about 14 percent shy of the peak reached in 1981. Farm real estate values have been growing at an average annual rate of 5.9 percent in nominal terms over the past five years (2000–2004) and 4 percent in inflation-adjusted terms.

While there is no expectation of a sudden drop in farm real estate values, a number of factors, such as lower commodity prices, higher interest rates, lack of irrigation water, and reduced government payments, could slow their rise or even reduce them in some of the more remote rural areas. However, farmers and lenders are in a generally better financial position today than in the past two decades and should be able to withstand at least minor market corrections to farmland values, if they occur.

After Record Year, Agricultural Exports Expected to Decline

U.S. agricultural exports reached a record $62.3 billion for fiscal year 2004 (October 2003 through September 2004), up nearly 11 percent from last year and exceeding the previous record in fiscal year 1996 by 4 percent. Export growth in FY 2004 reflects higher volumes and higher prices for feed grains, rice, cotton, beef, and many horticultural products. The improved performance was due to the weaker value of the dollar; strong global economic growth; reduced competition for wheat, corn, and cotton markets; and China's robust demand for oilseeds and cotton.

The strong export showing occurred despite trade bans by various countries over animal disease outbreaks in the United States—the discovery in December 2003 of a single cow infected with bovine spongiform encephalopathy (BSE), and the discovery of avian influenza in a few poultry flocks in Delaware, New Jersey, Pennsylvania, and Texas in early 2004. Fiscal year 2005 exports are forecast to decline about 10 percent to $56 billion. The expected drop is attributed to a slowdown in global economic activity in 2005, high transportation costs associated with rising oil prices, increased foreign competition, and lower prices for cotton, wheat, and soybeans owing to a rebound in global supplies. Trade disputes over animal and plant health issues could also constrain export potential in 2005.

On the other side of the trade ledger, U.S. agricultural imports jumped 15 percent to a record $52.7 billion in FY 2004, the 17th consecutive increase and the largest increase since 1984. Agricultural imports are forecast to reach another record in FY 2005 and could match exports at $56 billion. The recent accelerated import growth (27 percent over the past two years) is attributed to an abundant variety of processed food products and fresh produce from abroad, along with U.S. consumers' strong appetite for imported specialty foods, beer, and wine. Horticultural products account for nearly half the growth in recent years; the bulk of these products come from Central America and from Asian countries. Other major suppliers of food and beverage products to the U.S. market include the European Union (EU), Canada, and Australia. The competitive pressure is being felt by fruit and vegetable producers across America, particularly by the smaller high-cost producers, who have seen an erosion of their markets by less expensive imports. This situation calls into question the future viability of some of these operations, which will need to adapt to the changing landscape or sell out to larger, more efficient operations.

The agricultural trade balance (exports minus imports) fell to just $9.6 billion in FY 2004, the lowest surplus since 1987. With the current forecast showing U.S. agricultural trade in a virtual balance, the United States could become a net importer of agricultural products for the first time since 1959. The United States may no longer be able to rely on an agricultural trade surplus to help offset the trade deficit in petroleum and manufactured products.

Food Safety and Security Concerns

The financial health of farmers, ranchers, and their credit providers depends on the continue recognition of the United States as a world leader in food safety and security. Outbreaks of animal and plant diseases, incidences of microbial pathogens in the food supply, consumer resistance to biotechnology, and concerns over possible terrorist attacks on the food supply have prompted the United States to augment its surveillance and safety procedures in recent years. The discovery of a single case of BSE in late December 2003 caused a sharp decline in U.S. beef exports in 2004, as most importing countries banned U.S. beef products and live animals. The U.S. Department of Agriculture and the Food and Drug Administration responded by implementing a series of Federal measures this year to strengthen safeguards put in place in 1989 to mitigate the risk of BSE entering the U.S. food chain. Consumer response to these measures has

been generally favorable, and beef consumption increased in 2004, following a decline in 2003. A second positive test result for BSE in the future would likely delay the resumption of U.S. beef export trade and could generate a much more negative consumer response.

Another food safety challenge during 2004 was the discovery in February of avian influenza in a limited number of poultry operations in four states: Delaware, New Jersey, Pennsylvania, and Texas. The strain of virus posed no threat to humans but resulted in temporary trade bans by some countries. U.S. poultry exports declined somewhat in 2004, while domestic consumption increased. U.S. farmers will need to remain vigilant in protecting their flocks from infectious diseases if they are to regain the record level of exports they enjoyed in 2001.

During November and December 2004, the USDA confirmed for the first time the presence of the highly contagious Asian soybean rust in a number of Southeastern and lower Midwestern states. The plant disease poses no health risk to humans but can sharply reduce soybean yields. Fortunately, the disease had virtually no impact on the 2004 crop, as it came near the end of the harvest season. Scientists, who anticipated the disease's arrival from South America, believe it came to the United States as a result of a very active hurricane season this year. The USDA, along with the state extension services, has launched an aggressive information campaign for producers about effective surveillance and fungicide application methods. The cost of treatment is estimated at about $25 an acre on average, or about a 15 percent increase in costs. According to USDA's Risk Management Agency, production losses from soybean rust are an insurable event, provided the insured producer can verify that the cause was natural (not agroterrorism) and that available control measures were properly applied. There is likely to be some shift out of soybean acreage in 2005 as some farmers choose to limit their exposure to the rust rather than spray for the disease. The extent of the acreage shift will not be known until late in the spring. The trade impacts from the discovery of Asian soybean rust probably will be minimal, as the pathogen exists in most soybean-producing countries.

Agricultural biotechnology is a collection of scientific techniques used to improve plants, animals, and microorganisms to benefit the food and agriculture system through reduced chemical and fuel use, enhanced nutrition, and economic benefits for producers. However, these technologies are not without risk. Since 1987, the United States has tested more than 10,000 genetically engineered organisms and has deregulated only 60 products. Biotech varieties of corn, cotton, and soybeans have been commercially available since 1996, with their use climbing in most years. The EU imposed a moratorium in 1998 on approving agricultural biotech products for import or use, thereby restricting U.S. exports to that market. Other countries, particularly food-importing developing countries with strong ties to the EU, have also restricted imports of biotech products. In May 2004, the EU approved its first biotech product in six years, a variety of sweet corn, which will have to be clearly labeled as a biotech product. However, consumer resistance in Europe to biotech products remains strong, so the export potential of biotech products to the EU market is uncertain.

Corporate Activity, Regulatory Guidance, and Other Agency Activities

FCS Corporate Activity Slows Significantly in FY 2004

In FY 2004, the level of corporate activity among associations subsided from that of previous years. An Agricultural Credit Association with wholly owned Production Credit Association and Federal Land Credit Association subsidiaries (the ACA parent/subsidiary structure) remained the dominant association structure in the System and accounted for 87 percent of all associations as of September 30, 2004.[40] Under this structure, the ACA and its subsidiaries operate with a common board of directors and joint employees and are obligated on each other's debts and liabilities. The structure allows the ACA to build capital more efficiently and enables customers to be stockholders of one entity—the ACA—and borrowers from the ACA or either or both subsidiaries. This structure gives the ACA and its subsidiaries greater flexibility in serving their customers and allows credit and related services to be delivered to borrowers more efficiently. Of the 86 ACAs, only two have not yet adopted the ACA parent/subsidiary structure. However, in FY 2004, these two ACAs received preliminary approval from the FCA Board to restructure. If their stockholders approve and FCA grants final approval, they will operate under the ACA parent/subsidiary structure beginning January 1, 2005.[41] Also, 11 FLCAs, which are authorized to provide long-term credit, continue as independent associations. This section describes the changes in the FCS structure that occurred during FY 2004.

Summary of Activity

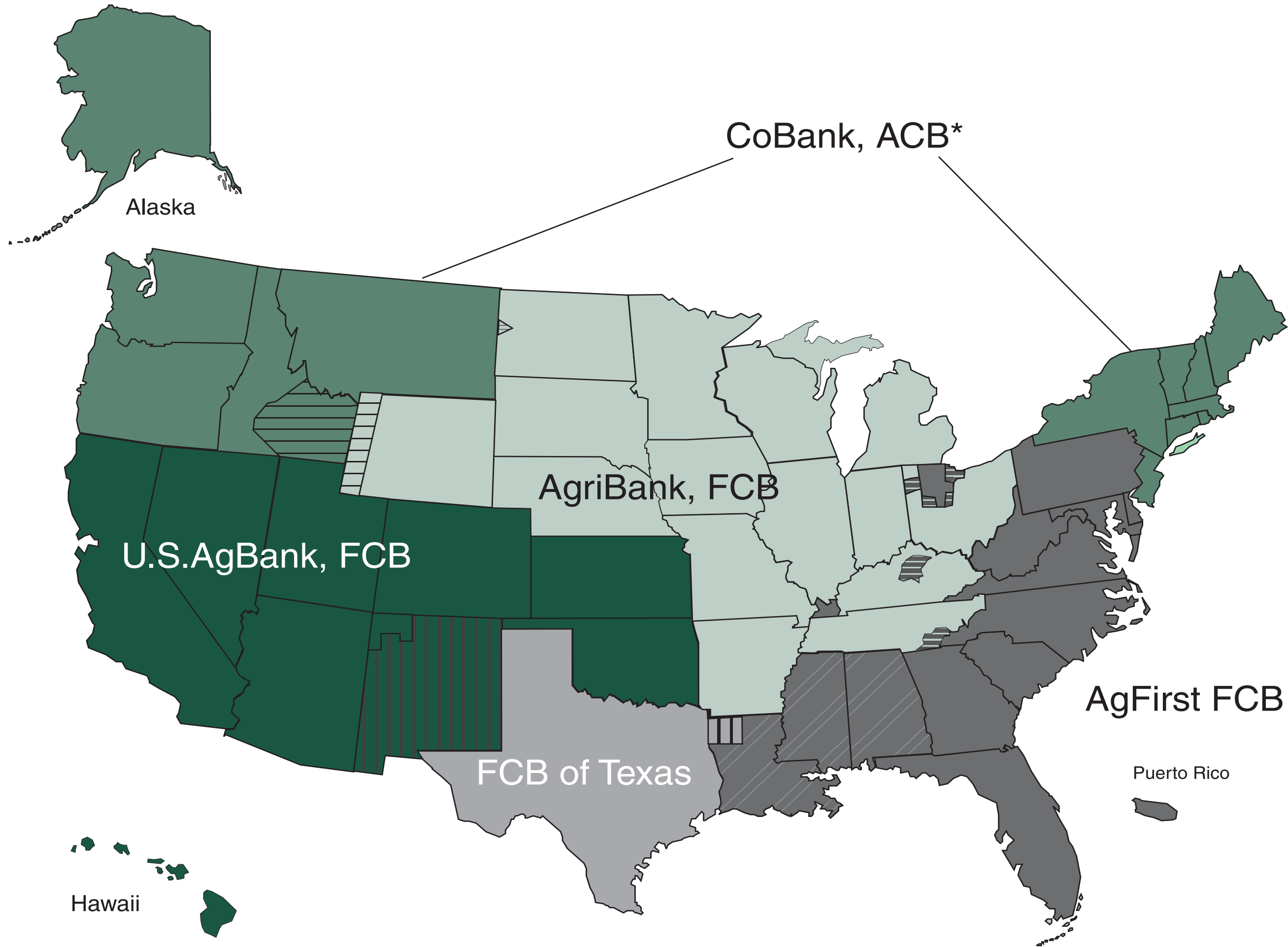
The number of corporate applications submitted for FCA Board approval declined from the previous year. In FY 2004, we analyzed and approved seven applications, compared with eight applications processed in 2003. The applications processed were for

- the restructuring of two ACAs to establish a PCA and an FLCA as wholly owned subsidiaries of each ACA;
- a merger of two ACAs;
- a merger of two FLCAs;
- amendments to the charters of an ACA and its FLCA subsidiary authorizing them to provide long-term real estate mortgage loans in the territory where the ACA was previously limited to short- and intermediate-term lending and where the FLCA had no lending authority;
- a conversion of an FLCA to an ACA through creation of a PCA with which the FLCA consolidated to establish the ACA with a parent/subsidiary structure; and
- an amendment to the articles of incorporation for a service corporation.

The total number of associations decreased from 99 on September 30, 2003, to 97 on September 30, 2004. The number of banks remains at five. This number reflects the merger of Western Farm Credit Bank into the Farm Credit Bank of Wichita to form U.S. AgBank, FCB, which occurred October 1, 2003, and was summarized in last year's Annual Report. Figure 10 shows the chartered territory of each FCS bank. More details about specific corporate applications in FY 2004 are available on FCA's Web site, www.fca.gov.

40. FCA, in approving the ACA parent/subsidiary structure, views the ACA and its wholly owned operating subsidiaries as a single entity for most regulatory and examination purposes based on their common ownership and control and cross-guarantees between and among the entities, with each entity responsible for the debts of the others and their capital and assets combined to absorb any losses.
41. Stockholders of these two ACAs approved the restructurings, which became effective January 1, 2005.

Figure 10
Farm Credit System Banks Chartered Territories
As of September 30, 2004



U.S. AgBank, FCB	FCB of Texas	AgriBank, FCB	CoBank, ACB	AgFirst FCB
27 ACA Parents♦ 3 FLCAs	13 ACA Parents♦ 8 FLCAs	18 ACA Parents♦	5 ACA Parents♦	21 ACA Parents♦ 2 ACAs

Ag New Mexico, Farm Credit Services, ACA is funded by the FCB of Texas. Farm Credit of New Mexico, ACA is funded by U.S. AgBank, FCB.

The FLCAs in Alabama, Louisiana, and Mississippi are funded by the FCB of Texas. First South Farm Credit, ACA is funded by AgFirst FCB.

Louisiana Ag Credit, ACA is funded by the FCB of Texas.

AG Credit, ACA (Ohio), Central Kentucky ACA (Kentucky), Chattanooga ACA (Tennessee), and Jackson Purchase ACA (Kentucky) are funded by AgFirst FCB.

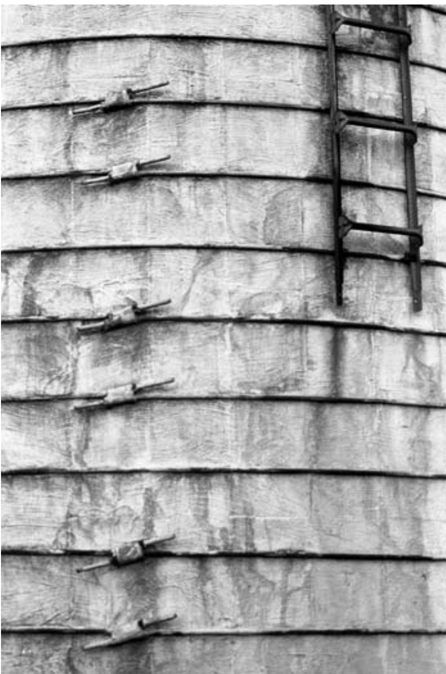
Mid-America ACA, funded by AgriBank, FCB, is also authorized to lend in this territory.

Idaho ACA is funded by U.S. AgBank, FCB.

Teton, Lincoln, and Uinta counties in Wyoming are chartered to AgriBank, FCB and U.S. AgBank, FCB.

*** CoBank, ACB is headquartered in Denver, Colorado, and serves cooperatives nationwide and ACAs in the indicated areas.**

♦ Designates ACAs that have PCA and FLCA subsidiaries.



Termination of System Status

In July 2004, FCA was notified by Farm Credit Services of America, ACA (FCSA), an association with total assets of $7.8 billion, that it planned to terminate its status as a System institution, as permitted by the Farm Credit Act and FCA regulations. As of June 30, 2004, FCSA provided credit and related services to 48,361 stockholders in Iowa, Nebraska, South Dakota, and Wyoming. It operates as an ACA parent with subsidiaries. On August 3, 2004, FCA received FCSA's commencement resolution, which the board of directors of the ACA and its subsidiaries adopted on July 30, 2004. The commencement resolution is required by FCA regulations and signifies that the board has directed management to begin the termination process. The resolution indicated that FCSA had approved a plan of merger under which it would be acquired by a subsidiary of Rabobank, a Dutch-owned financial services corporation. The successor institution would be organized as a Nebraska corporation. FCSA also notified its equity holders that it was taking steps to terminate its System status. As FCA regulations require, the notice briefly described the termination process, the expected effect of the termination on equity holders, and the type of charter that the successor institution would have. FCA did not receive a termination application from FCSA. On October 19, 2004, the FCSA board of directors reversed its decision to seek a termination of System status; the board advised FCA of its action on October 20, 2004. Simultaneously, the FCSA board also rejected a merger offer tendered by another System association.

Regulations

FCA routinely issues regulations, policy statements, and regulatory positions to ensure that the Farm Credit System complies with the law, operates in a safe and sound manner, and efficiently carries out its statutory mission. The following paragraphs describe some of our efforts during FY 2004.

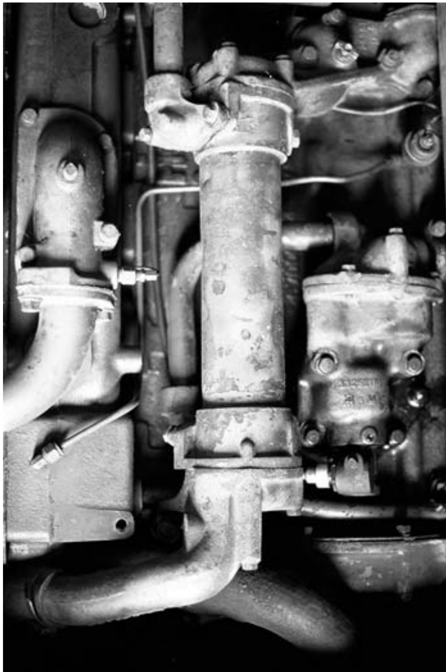
Young, Beginning, and Small Farmers and Ranchers

We completed our final rule that amends our regulations governing the Farm Credit System's mission to provide sound and constructive credit and services to young, beginning, and small farmers and ranchers and producers or harvesters of aquatic products (YBS farmers and ranchers, or YBS). The farmers and ranchers rule requires System banks to ensure that their affiliated direct-lender associations adopt YBS programs, as required by statute, under the policies of the System banks. The final rule will, among other things, (1) require Farm Credit bank policies on YBS programs to focus on ensuring that direct-lender associations adopt YBS programs in fulfillment of the explicit requirements of § 4.19 of the Act; (2) establish minimum components that each direct-lender association must have in its YBS program, including a YBS mission statement, quantitative targets, qualitative goals, and risk management methods to ensure safety and soundness; (3) require each association to include YBS program quantitative targets and qualitative goals in its operational and strategic business plan; and (4) require System banks and associations to disclose YBS performance information in their published annual reports. The rule gives System associations the flexibility to design programs unique to the needs of

the YBS borrowers in the territories they serve. (Adopted March 11, 2004; published March 30, 2004 [69 FR 16460]; effective May 10, 2004.)

Other Financing Institutions
We completed a final rule that amends our regulations governing the funding and discounting of loans for non-System other financing institutions (OFIs) by the Farm Credit banks. The final rule on OFIs will ensure that farmers and ranchers have broader access to competitive and reliable credit. The final rule is designed to make it easier for OFIs to obtain funding for short- and intermediate-term loans to farmers, ranchers, aquatic producers and harvesters, and rural homeowners through System banks. The rule streamlines the existing regulations to increase the flow of credit, removes provisions that do not enhance safety and soundness, and amends existing capital adequacy regulations for OFIs. The final rule makes it easier for OFIs to fund and discount loans with a Farm Credit bank of its choice. FCA also strengthened provisions of the regulations that require Farm Credit banks to treat their OFIs and associations equitably. The final rule complements other efforts we are exploring to increase the flow of credit to agriculture and rural America by promoting greater cooperation between System and non-System lenders. (Adopted April 22, 2004; published May 26, 2004 [69 FR 29852]; effective July 22, 2004.)

Investments in Farmers' Notes
We issued a reproposed rule that would amend our regulations governing the System's investments in Farmers' Notes and related capital risk-weighting requirements. The rule is designed to increase the flow of credit to farmers, ranchers, aquatic producers and harvesters, and farm-related businesses by promoting greater cooperation between System and non-System lenders through the removal of unnecessary regulatory restrictions. The proposed rule would make significant revisions to our Farmers' Notes regulations. If adopted, the rule will expand the Farmers' Notes program to more non-System lenders and allow all System associations to invest, for the first time, in both long- and short-term loans between these other lenders and eligible farmers and ranchers. The new rule also would allow obligations of aquatic producers and harvesters and farm-related businesses to qualify for the Farmers' Notes program for the first time. The proposed rule, in combination with other powers, would give System associations more flexibility to meet the funding needs of a wide variety of non-System lenders that finance agriculture. The rule, in conjunction with new OFI regulations, would enhance the ability of non-System lenders to access any one or a combination of the System's funding programs, depending on their individual needs. The rule would enhance the System's ability to fulfill its mission to finance agriculture by serving as a steady source of funding and liquidity for other lenders. In addition, the rule would differentiate the capital risk weighting of System institutions' investments in Farmers' Notes, depending on the structure and risk-mitigating characteristics of the non-System financial institutions. The rule could lower credit costs and provide more credit options for farmers, ranchers, aquatic producers and harvesters, and farm-related businesses. (Adopted August 12, 2004; published September 14, 2004 [69 FR 55362]; comment period ended October 14, 2004.)



Distressed Loan Restructuring
We completed a final rule that amends portions of our borrower rights regulations governing (1) an applicant's or borrower's right to review certain loan decisions; (2) a borrower's right to receive notice when a loan becomes distressed and the opportunity to request a restructuring of a distressed loan; and (3) the right of first refusal to repurchase or lease agricultural real estate following foreclosure or voluntary conveyance. Since our initial publication of borrower rights rules on September 14, 1988, we have observed differences in how FCS institutions apply these regulations and have reviewed complaints from applicants and borrowers regarding their rights. We also have received comments from FCS institutions and the public on our borrower rights regulations in response to a June 23, 1993, regulatory burden solicitation. As a result of our deliberation, we believe the final rule clarifies existing provisions, responds to comments, and reorganizes the rule into one distinct section of our regulations. This final rule will help agricultural borrowers and System institutions better understand the rights Congress has afforded applicants and FCS borrowers. The final rule places all borrower rights provisions in one part of our regulations in an enhanced, user-friendly format that borrowers can use to better understand requirements for their treatment. (Adopted February 10, 2004; published March 9, 2004 [69 FR 10901]; effective April 19, 2004.)

Effective Interest Rate Disclosure
We adopted a final rule that amends our regulations governing disclosure of effective interest rates (EIRs) and related information on loans. The final rule clarifies the current rule as to when and how (1) qualified lenders must disclose the EIR and other loan information to borrowers; (2) the cost of System borrower stock must be disclosed to borrowers; and (3) loan origination charges and other loan information must be disclosed to borrowers. The final rule requires lenders to use a discounted cash flow method in determining the EIR to provide meaningful disclosures to borrowers but, in keeping with our Agency's regulatory philosophy, does not prescribe detailed calculation procedures. The rule also clarifies how effective interest rates on loans should be determined. The final rule has rewritten the existing EIR regulations in plain language and in a question-and-answer format to make them easier for borrowers and lenders to understand, and it updates and clarifies FCA regulations to ensure that System borrowers receive the rights and protections granted by Congress while not placing unnecessary burdens on FCS institutions. (Adopted March 11, 2004; published March 30, 2004 [69 FR 16455]; effective May 10, 2004.)

Credit and Related Services
We adopted final amendments to our regulations governing domestic and international lending, certain intra-System agreements concerning similar entity participation transactions, provisions of general financing agreements, and related services. These amendments bring our regulations into conformity with changes in the Farm Credit Act resulting from the 2002 Farm Bill; address comments we received requesting that FCA reduce regulatory burden; ensure compliance with the Act; and clarify certain provisions in our existing regulations. (Adopted June 10, 2004; published July 21, 2004 [69 FR 43511]; effective November 19, 2004.)

Capital Adequacy—Risk-Weighting Revisions
We completed a proposed rule that would amend certain capital adequacy regulations for FCS institutions to help ensure the long-term safety and soundness of the System by more closely aligning capital requirements with risk. The proposed rule would amend our risk-based capital treatment of FCS recourse obligations, direct credit substitutes, residual interests, asset- and mortgage-backed securities, guarantee arrangements, claims on securities firms, and certain qualified residential loans. The rule would also make our regulatory capital treatment for FCS institutions more consistent with the guidance of other financial regulatory agencies, thus reflecting changes in the financial marketplace. (Adopted June 10, 2004; published August 6, 2004 [69 FR 47983]; comment period ended November 4, 2004.)

Capital Adequacy—Preferred Stock
We adopted a proposed rule that would amend the regulatory capital treatment of preferred stock issued by FCS institutions and place certain restrictions on the retirement of preferred stock. The proposed rule would require greater board oversight in the retirement of preferred stock, enhance the current standards-of-conduct regulations to address certain preferred stock transactions, and require disclosure of senior officer and director preferred stock transactions. (Adopted April 22, 2004; published June 4, 2004 [69 FR 31541]; comment period ended August 3, 2004.)

Farmer Mac Nonprogram Investment and Liquidity
We proposed regulations governing the Federal Agricultural Mortgage Corporation in the areas of nonprogram investments and liquidity. Our proposed regulations would ensure that Farmer Mac holds only high-quality liquid investments to maintain a sufficient liquidity reserve, invest surplus funds, and manage interest-rate risk, while not holding excessive amounts of nonprogram investments considering Farmer Mac's status as a government-sponsored enterprise. (Adopted April 22, 2004; published June 14, 2004 [69 FR 32905]; comment period ended August 13, 2004.)

Loan Syndications
After soliciting public comment about the proper regulatory treatment of System loan syndication transactions, we issued a final notice with the guidance that the System requested about the regulatory treatment of syndicated loans to eligible borrowers. The final notice reaffirmed our long-standing interpretation that syndicated loans to eligible borrowers come within System banks' and associations' lending powers, not their loan participation authorities. The guidance in the final notice informs System institutions that take part in syndicated loans to eligible borrowers that they must comply with all applicable provisions of the Farm Credit Act and regulations that govern direct loans. Only FCS banks and associations that are direct lenders can take part in syndications. Borrower rights and territorial concurrence apply to FCS associations that are involved in syndications. CoBank and FCS associations must sell stock to the borrower on syndicated loans, and they must maintain a first lien on the stock. System lenders cannot buy

assignments in syndicated loans from non-System lenders after closing. The guidance states that, from a safety and soundness perspective, each System institution must understand the risks associated with syndications, and the policies of its board must establish methods for measuring and managing these risks. (Adopted February 10, 2004; published February 24, 2004 [69 FR 8407].)

Funding Activity

The FCS raises funds for loans by the sale of debt securities through the Federal Farm Credit Banks Funding Corporation,[42] the fiscal agent for the Farm Credit banks. Through this conduit, funds flow from worldwide capital market investors to agriculture and rural communities, providing them with efficient access to global resources. Systemwide debt securities are issued as discount notes, master notes, bonds, designated bonds, or global debt securities.

As required by the Farm Credit Act, the System must obtain FCA approval for all funding requests. For the 12 months ending September 30, 2004, the FCS issued $334 billion in debt, in line with the $332 billion issued during the same period in 2003 but well below the $448 billion issued in 2002. Overall issuance has declined as a result of the Farm Credit banks' extension of the maturity of their debt. This debt extension was in response to a new internal minimum liquidity standard that each Farm Credit bank agreed to achieve, and to the banks taking advantage of the historically low interest rate levels.

Data Reporting

During the year, we maintained financial and operational information about Farm Credit System institutions that was easily accessible to the public through the Agency's Web site. We continued to provide electronic access to each System institution's quarterly Call Report submission, which provides financial and operational information in the form of a balance sheet, an income statement, and a series of supporting schedules. Along with Call Report information, we provided public access to various analytical reports[43] and additional operational data, including the following:

- the Uniform Peer Performance Report, which is a comparison report of one FCS institution to a group of FCS institutions of similar asset size;
- the Six-Quarter Trend Report and the Six-Year Trend Report, which show trend information for individual FCS institutions;
- the Institution Comparison Report, which is a comparison report of up to six selected FCS institutions; and
- the YBS Report, which provides annual data on the lending activities of FCS institutions for young, beginning, and small farmers and ranchers.

In FY 2004, the Agency continued its effort to reevaluate the collection of loan-level data in a systematic and uniform manner from all System institutions. The Agency currently collects loan-level data consistent with Loan Account Reporting System-Modified (LARS-M) requirements. LARS-M, however, does not reflect significant technological advancements in the collection of loan-level data by System institutions that have occurred since LARS-M was implemented. The Agency is considering ways to enhance the collection of loan-level data for regulatory and supervisory oversight purposes.

42. Headquartered in the greater New York City area, the Funding Corporation's primary function is to issue, market, and handle debt securities on behalf of the System banks. In addition, the Funding Corporation assists the System banks with respect to a variety of asset/liability management and specialized funding activities. The Funding Corporation is the financial spokesperson for the Farm Credit System and is responsible for financial disclosure and the release of public information concerning the financial condition and performance of the System as a whole.
43. The reports present information in various relational formats, including key financial ratios, percentages, and dollar amounts. The reports show a condensed balance sheet and income statement, as well as other areas on capital, assets, earnings and profitability, and liquidity.

Oversight of Farmer Mac

Farmer Mac is a stockholder-owned, federally chartered instrumentality of the United States, created in 1988 to establish a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac conducts its business primarily through two core programs: Farmer Mac I and Farmer Mac II. Under the former, Farmer Mac purchases, or commits to purchase, qualified loans or obligations backed by qualified loans that are not guaranteed by any instrumentality or agency of the United States. Under the latter, Farmer Mac purchases the guaranteed portions of farm ownership and farm operating loans, rural business and community development loans, and certain other loans guaranteed by USDA.

Farmer Mac is regulated by FCA through the Office of Secondary Market Oversight (OSMO), which was established in 1992 by Public Law 102-237. OSMO provides for the examination and general supervision of Farmer Mac's safe and sound performance of its powers, functions, and duties. The statute requires that OSMO constitute a separate office, reporting to the FCA Board, and that its activities, to the extent practicable, be carried out by individuals not responsible for the supervision of the banks and associations of the FCS.

The Agency, through OSMO, performs annual comprehensive CAMELS-based examinations and supervision of Farmer Mac's operations and condition for safety and soundness and mission achievement. This examination and supervision work includes the ongoing review of Farmer Mac's compliance with the risk-based capital regulations and ongoing supervision of its operations and condition throughout the year. Table 7 summarizes Farmer Mac's balance sheet at the end of the third quarter for six years.

Table 7

Farmer Mac Condensed Balance Sheets, 1999–2004

As of September 30

Dollars in Millions

	1999	2000	2001	2002	2003	2004	Growth Rate 2003–2004
Total Assets	$2,681.5	$3,035.1	$3,337.2	$4,031.6	$4,196.4	$3,784.9	-10%
Total Liabilities	$2,594.0	$2,935.5	$3,247.5	$6,836.1	$3,992.3	$3,556.8	-11%
Net Worth or Equity Capital	$87.4	$99.6	$129.7	$195.5	$204.1	$228.1	12%

Source: Farmer Mac's Third Quarter Security and Exchange Commission Form 10-Q.

Capital

By statutory design, secondary market government-sponsored enterprises, such as Farmer Mac, operate with lower statutory capital margins than primary market lenders. Accordingly, monitoring the capital levels of Farmer Mac is a central component of FCA's oversight programs.

On September 30, 2004, Farmer Mac's net worth (i.e., generally accepted accounting principles (GAAP) equity capital) was $228.1 million, compared with $204.1 million a year earlier. Net worth was 6.0 percent of on-balance-sheet assets as of September 30, 2004. When Farmer Mac's off-balance-sheet program assets (i.e., guarantee obligations) are added to total on-balance-sheet assets, capital coverage is 3.2 percent. In August 2004, Farmer Mac announced a new common stock dividend policy and a stock repurchase program. While these policies will affect earnings and outstanding common shares, Farmer Mac is expected to continue to meet statutory and regulatory capital requirements.

Farmer Mac's core capital (the sum of the par value of outstanding common stock, the par value of outstanding preferred stock, paid-in capital, and retained earnings) remained above the statutory minimum requirement, and its regulatory capital (core capital plus allowance for losses) exceeded the required amount of regulatory capital as determined by the risk-based capital stress test. Farmer Mac's core capital continued its upward trend and, at September 30, 2004, totaled $233.6 million, exceeding the statutory minimum capital requirement[44] of $128.1 million by $105.5 million. Farmer Mac's regulatory capital totaled $256.1 million at September 30, 2004, exceeding the regulatory risk-based capital requirement of $43.5 million by $212.6 million. Regulatory capital was 5.3 percent of total Farmer Mac I program volume (on- and off-balance sheet). Table 8 offers a historical perspective on capital and capital requirements for the past six years at the quarter ending September 30. In the coming year, FCA plans to publish proposed revisions to the risk-based capital regulations that became effective in 2002.

In addition to program assets, Farmer Mac's capital supports nonprogram investment needs. Nonprogram investments provide liquidity in the event of a short-term disruption in the capital markets that prevents Farmer Mac from issuing new debt. Nonprogram investments are investment securities, cash, and cash equivalents. Farmer Mac's policy is to maintain nonprogram investments at levels that provide liquidity for a minimum of 60 days of maturing obligations, with a target of 90 days. Farmer Mac was in compliance with its liquidity policy throughout the year.

Program Activity

Farmer Mac's total program activity dropped slightly over the past year, to $5.5 billion on September 30, 2004, from $5.6 billion a year earlier (see Figure 11). Farmer Mac attributes the slowing growth to increased liquidity levels of rural banks and Farm Credit System associations; a reduced level of mortgage refinancing activity owing to the rising interest rate environment; and the cautionary guidance the Farm Credit Administration and the Farm Credit System Insurance Corporation provided to FCS institutions regarding counterparty risk.

Before the recent downward trend in program activity, Farmer Mac's Long-Term Standby Commitment to Purchase (LTSCP or Standby) product was the primary source of growth in program activity over the past four years. Under Farmer Mac Standbys, a financial institution pays an annual fee in return for Farmer Mac's commitment to purchase loans in a specific pool under specified conditions at the option of the institution. The Standby product has grown rapidly since its introduction in 1999, from $862.8 million at December 31, 2000, to $2.4 billion at September 30, 2004. Standby volume now accounts for 42.9 percent of Farmer Mac's total program activities.

44. The statute requires 2.75 percent capital coverage for on-balance-sheet assets and 0.75 percent for off-balance-sheet obligations.

Table 8

Farmer Mac Capital Positions, 1999–2004

As of September 30

Dollars in Millions

	1999	2000	2001	2002	2003	2004
GAAP Equity	$87.4	$99.6	$129.7	$195.5	$204.0	$228.1
Core Capital	$88.8	$98.3	$116.3	$181.1	$206.4	$233.6
Statutory Requirement	$79.8	$93.6	$108.1	$129.7	$137.7	$128.1
Regulatory Requirement	NA	NA	NA	$59.4	$45.5	$43.5
Excess over Statutory or Regulatory Requirement[1]	$9.0	$4.7	$8.2	$51.4	$68.7	$105.5
Capital Margin Excess > Minimum	11.2%	5.0%	7.6%	39.6%	49.9%	82.4%

1. Farmer Mac is required to hold capital at the higher of the statutory minimum capital requirement or the amount required by FCA regulations as determined by the Risk-Based Capital Stress Test model.

NA = Not Available

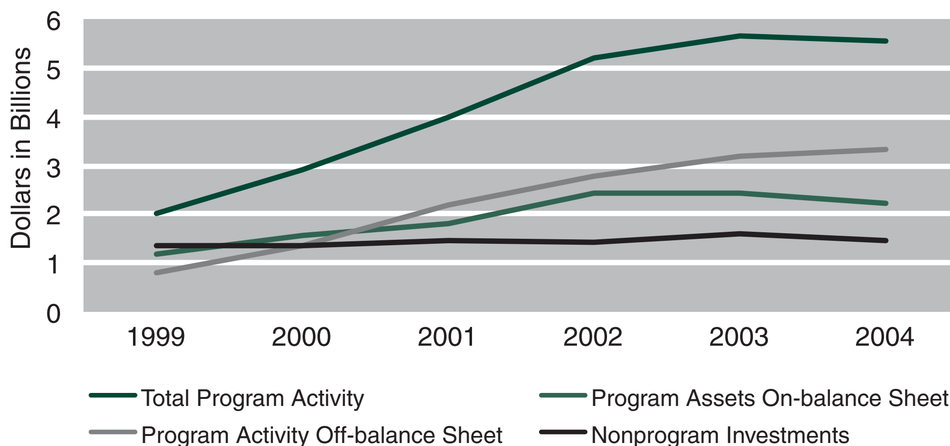
> = Greater Than

Source: Farmer Mac's Third Quarter Security and Exchange Commission Form 10-Q.

Figure 11

Farmer Mac Program Activity and Nonprogram Investment Trends, 1999–2004

As of September 30



Source: Farmer Mac's Third Quarter Security and Exchange Commission Form 10-Q.

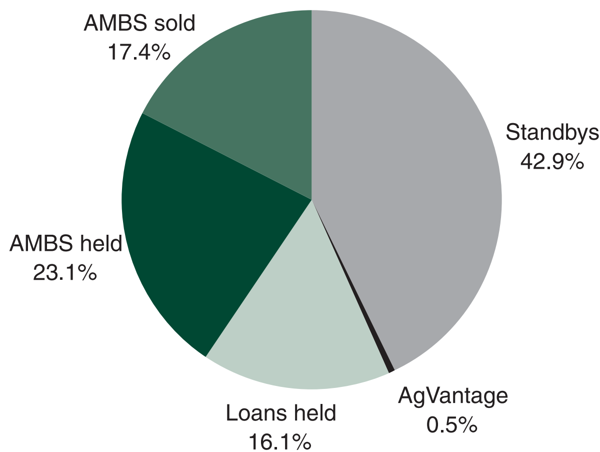
Off-balance-sheet program activity is composed of agricultural mortgage-backed securities (AMBS) held by investors (AMBS sold) and Standbys. At the end of September 2004, 60.3 percent of program activity was off-balance-sheet obligations (see Figure 12).

Asset Quality

On September 30, 2004, the portion of the Farmer Mac I program portfolio that was nonperforming was $75.0 million in loan principal, or 1.58 percent of the principal balance of all loans purchased, guaranteed, or committed to be purchased since enactment of the Farm Credit System Reform Act of 1996 (1996 Act).[45] This compares with $84.6 million, or 1.74 percent, on September 30, 2003. Nonperforming assets are those that are 90 or more days past due, in foreclosure, or in bankruptcy, or real estate owned, that is, property acquired by Farmer Mac through foreclosure. Real estate owned at September 30, 2004, was $7.3 million, down significantly from $16.4 million a year earlier. Farmer Mac attributes the decreasing trend in the total dollar amount of nonperforming assets over the past year to the maturing of a significant segment of its portfolio beyond the peak default years.

On September 30, 2004, Farmer Mac's allowance for losses totaled $22.5 million, compared with $22.7 million on September 30, 2003. Of the $22.5 million allowance, $1.3 million represents specific allowances related to undercollateralized nonperforming assets. Figure 13 shows the level of Farmer Mac's allowance and nonperforming assets relative to outstanding post-1996 Act program volume. Post-1996 Act volume is used in the figure in consideration of the minimal risk associated with pre-1996 Act program activity.

Figure 12
Farmer Mac's Total Program Activity
As of September 30, 2004



Source: Farmer Mac's Third Quarter Security and Exchange Commission Form 10-Q.

45. Farmer Mac assumes 100 percent of the credit risk on post-1996 Act loans, whereas pre-1996 Act loans are supported by mandatory 10 percent subordinated interests that mitigate Farmer Mac's exposure. For that reason, pre-1996 Act loans are excluded from analysis for comparison purposes.

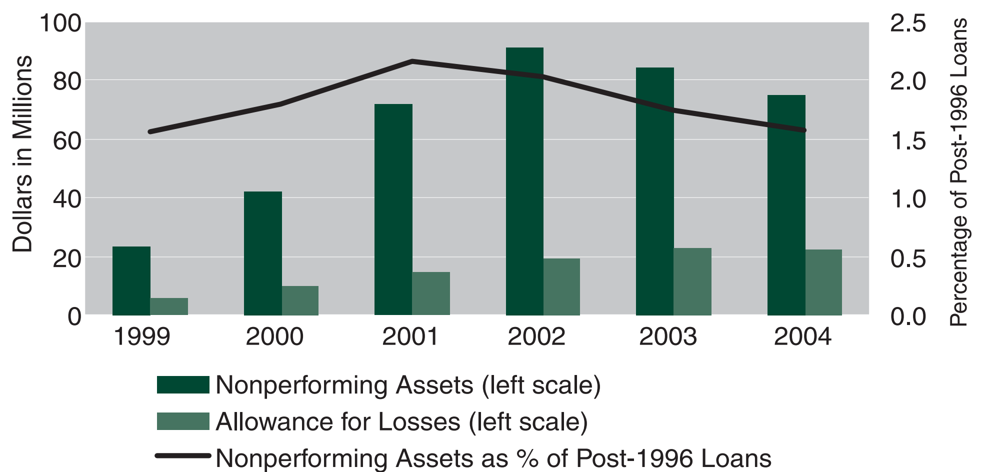
Earnings

GAAP net income available to common stockholders for the nine months ending September 30, 2004, was $18.4 million, down $1.7 million (8.7 percent) from the same period in 2003. Core earnings[46] for the first nine months of 2004 were $17.5 million, an increase of 1.9 percent over the same period in 2003. Net interest income, which excludes guarantee fee income, was $22.9 million net of the provision for loan losses for the first nine months of 2004, slightly higher than in 2003. Guarantee fee income was also slightly higher at the end of September 2004 than it was at the end of September 2003, at $15.7 million. Nonprogram investments accounted for an estimated 23 percent of interest income for the three quarters ending September 30, 2004, up from 22 percent for the first three quarters of 2003. Table 9 shows trends in key income components since September 30, 1999.

Figure 13

Allowance and Nonperforming Asset Trends, 1999–2004

As of September 30



Source: Farmer Mac's Third Quarter Security and Exchange Commission Form 10-Q.

Table 9

Farmer Mac Condensed Statements of Operations, 1999–2004

For the 9 Months Ending September 30

Dollars in Millions

	1999	2000	2001	2002	2003	2004	Growth Rate 2003 to 2004
Total Revenues	16.5	21.8	30.4	43.6	41.8	44.5	6.5%
Total Expenses	11.4	14.2	19.6	25.1	21.6	26.1	20.5%
Net Income Available to Shareholders	5.0	7.6	10.8	18.5	20.1	18.4	-8.7%
Core Earnings	NA	NA	12.3	17.0	17.2	17.5	1.9%

NA = Not Available

Source: Farmer Mac's Third Quarter Security and Exchange Commission Form 10-Q.

46. Core earnings is a non-GAAP measure of financial results that excludes the effects of certain unrealized gains and losses and nonrecurring items. Farmer Mac began reporting core earnings to present an alternative measure of earnings performance. The components included in core earnings calculations are at the reporting entity's discretion.

Glossary

A

Agricultural Credit Association (ACA) — An ACA results from the merger of a Federal Land Bank Association or a Federal Land Credit Association and a Production Credit Association, and has the combined authority of the two institutions. An ACA borrows funds from a Farm Credit Bank or Agricultural Credit Bank to provide short-, intermediate-, and long-term credit to farmers, ranchers, and producers and harvesters of aquatic products. It also makes loans to these borrowers for certain processing and marketing activities, to rural residents for housing, and to certain farm-related businesses.

Agricultural Credit Bank (ACB) — An ACB results from the merger of a Farm Credit Bank and a Bank for Cooperatives, and has the combined authorities of those two institutions. An ACB is also authorized to finance U.S. agricultural exports and provide international banking services for farmer-owned cooperatives. CoBank is the only ACB in the Farm Credit System.

B

Bank for Cooperatives (BC) — A BC provides lending and other financial services to farmer-owned cooperatives, rural utilities (electric and telephone), and rural sewer and water systems. It is also authorized to finance U.S. agricultural exports and provide international banking services for farmer-owned cooperatives. The last remaining BC in the Farm Credit System, the St. Paul Bank for Cooperatives, merged with CoBank on July 1, 1999.

F

Farm Credit Act — The Farm Credit Act of 1971, as amended, is the statute under which the Farm Credit System operates. The Farm Credit Act recodified all previous acts governing the Farm Credit System.

Farm Credit Bank (FCB) — FCBs provide services and funds to local associations that, in turn, lend those funds to farmers, ranchers, producers and harvesters of aquatic products, rural residents for housing, and some agriculture-related businesses. On July 6, 1988, the Federal Land Bank and the Federal Intermediate Credit Bank in 11 of the 12 then-existing Farm Credit districts merged to become FCBs. The mergers were required by the Agricultural Credit Act of 1987. As of September 30, 2004, there were four FCBs: AgFirst Farm Credit Bank; AgriBank, FCB; Farm Credit Bank of Texas; and U.S. AgBank, FCB.

Farm Credit Leasing Services Corporation (Leasing Corporation) — The Leasing Corporation is a service entity owned by CoBank, ACB. It provides equipment leasing and related services to eligible borrowers, including agricultural producers, cooperatives, and rural utilities.

Farm Credit System Insurance Corporation (FCSIC) — The FCSIC was established by the Agricultural Credit Act of 1987 as an independent U.S. government–controlled corporation. Its purpose is to ensure the timely payment of principal and interest on insured notes, bonds, and other obligations issued on behalf of Farm

Credit System banks and to act as conservator or receiver of FCS institutions. The FCA Board serves ex officio as the Board of Directors for FCSIC; however, the Chairman of the FCA Board is not permitted to serve as the Chairman of the FCSIC Board.

FCA Financial Institution Rating System (FIRS) — The FIRS is similar to the Uniform Financial Institutions Rating System used by other Federal banking regulators. However, it has been modified by FCA to reflect the nondepository nature of Farm Credit System institutions. The FIRS provides a general framework for assimilating and evaluating all significant financial, asset quality, and management factors to assign a composite rating to each System institution. The ratings are described below.

Rating 1 — Institutions in this group are basically sound in every respect; any negative findings or comments are of a minor nature and are anticipated to be resolved in the normal course of business. Such institutions are well managed, resistant to external economic and financial disturbances, and more capable of withstanding the uncertainties of business conditions than institutions with lower ratings. These institutions exhibit the best performance and risk management practices relative to the institution's size, complexity, and risk profile. As a result, these institutions give no cause for regulatory concern.

Rating 2 — Institutions in this group are also fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. The nature and severity of deficiencies are not considered material and, therefore, such institutions are stable and able to withstand business fluctuations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. While areas of weakness could develop into conditions of greater concern, regulatory response is limited to the extent that minor adjustments are resolved in the normal course of business and operations continue in a satisfactory manner.

Rating 3 — Institutions in this category exhibit a combination of financial, management, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to asset quality and/or financial condition, such institutions may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Institutions that are in significant noncompliance with laws and regulations may also be accorded this rating. Risk management practices are less than satisfactory relative to the institution's size, complexity, and risk profile. Institutions in this category generally give cause for regulatory concern and require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, still make failure only a remote possibility if corrective actions are implemented.

Rating 4 — Institutions in this group have an immoderate number of serious financial or operating weaknesses. Serious problems or unsafe

and unsound conditions exist that are not being satisfactorily addressed or resolved. Unless effective actions are taken to correct these conditions, they are likely to develop into a situation that will impair future viability or constitute a threat to the interests of investors, borrowers, and stockholders. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. A potential for failure is present but is not yet imminent or pronounced. Institutions in this category require close regulatory attention, financial surveillance, and a definitive plan for corrective action.

Rating 5 — This category is reserved for institutions with an extremely high, immediate or near-term probability of failure. The number and severity of weaknesses or unsafe and unsound conditions are so critical as to require urgent external financial assistance. Risk management practices are inadequate relative to the institution's size, complexity, and risk profile. In the absence of decisive corrective measures, these institutions will likely require liquidation or some form of emergency assistance, merger, or acquisition.

Federal Agricultural Mortgage Corporation (Farmer Mac) — Farmer Mac was created with the enactment of the Agricultural Credit Act of 1987 to provide a secondary market for agricultural real estate and rural housing mortgage loans.

Federal Farm Credit Banks Funding Corporation (Funding Corporation) — The Funding Corporation, based in Jersey City, New Jersey, manages the sale of Systemwide debt securities to finance the loans made by Farm Credit System institutions. The Funding Corporation uses a network of bond dealers to market its securities.

Federal Intermediate Credit Bank (FICB) — The Agricultural Credits Act of 1923 provided for the creation of 12 FICBs to discount farmers' short- and intermediate-term notes made by commercial banks, livestock loan companies, and thrift institutions. The Farm Credit Act of 1933 authorized farmers to organize Production Credit Associations (PCAs), which could discount notes with FICBs. As a result, PCAs became the primary entities for delivery of short- and intermediate-term credit to farmers and ranchers. On July 6, 1988, the FICB and the Federal Land Bank in 11 of the 12 Farm Credit districts merged to become Farm Credit Banks. The mergers were required by the Agricultural Credit Act of 1987.

Federal Land Bank (FLB) — The Federal Farm Loan Act of 1916 provided for the establishment of 12 FLBs to provide long-term mortgage credit to farmers and ranchers, and later to rural home buyers. On July 6, 1988, the FLB and the Federal Intermediate Credit Bank in 11 of the 12 Farm Credit districts merged to become Farm Credit Banks. The mergers were required by the Agricultural Credit Act of 1987.

Federal Land Bank Association (FLBA) — FLBAs were lending agents for Farm Credit Banks. FLBAs made and serviced long-term mortgage loans to farmers, ranchers, and rural residents for housing. FLBAs did not own loan assets but made loans only on behalf of the Farm Credit Bank with which they were affiliated. As of October 1, 2000, there were no remaining FLBAs.

Federal Land Credit Association (FLCA) — An FLCA is a Federal Land Bank Association that owns its loan assets. An FLCA borrows funds from a Farm Credit Bank to make and service long-term loans to farmers, ranchers, and rural residents for housing.

G

Government-sponsored enterprise (GSE) — A GSE is a federally chartered corporation that is privately owned, designed to provide a source of credit nationwide, and limited to servicing one economic sector. Each GSE has a public or social purpose: to improve the availability of credit to agriculture, education, or housing. GSEs are usually created because the private markets did not satisfy a purpose that Congress deems worthy—either to fill a credit gap or to enhance competitive behavior in the loan market. Each is given certain features or benefits (called GSE attributes) to allow it to overcome the barriers that prevented purely private markets from developing. In some cases, the GSE receives public assistance only to get started; in other cases, the assistance is ongoing.

P

Production Credit Association (PCA) — PCAs are Farm Credit System entities that deliver only short- and intermediate-term loans to farmers and ranchers. A PCA borrows money from its Farm Credit Bank to lend to farmers. PCAs also own their loan assets. As of January 1, 2003, all PCAs were eliminated as independent, stand-alone, direct-lender associations when they merged and became ACA subsidiaries.

Employees of the Farm Credit Administration

A final word of thanks to our employees, whose dedication to excellence and hard work contribute to the accomplishment of the Agency's mission to ensure a safe, sound, and dependable source of credit and related services for agriculture and rural America.

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Additional Information

The *Farm Credit Administration 2004 Annual Report* is available on FCA's Web site at www.fca.gov. While supplies last, printed copies of this publication can be obtained without charge from

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The Federal Farm Credit Banks Funding Corporation prepares the financial press releases, the System's Annual and Quarterly Information Statements, and the System's combined financial statements contained therein, with the support of the System banks. Copies are available on the Funding Corporation's Web site at www.farmcredit-ffcb.com or from

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The Farm Credit System Insurance Corporation publishes an annual report. Copies are available on FCSIC's Web site at www.fcsic.gov or from

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In addition, FCS banks and associations are required by regulation to prepare annual and quarterly financial reports. Copies of these documents are available for public inspection at FCA headquarters in McLean, Virginia.

Copies Are Available From:
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